

*Credibility*  
**PROMISES**



NEW ZEALAND BUSINESS ROUNDTABLE  
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## FOREWORD

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

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

A full list of New Zealand Business Roundtable publications is also included.

R L Kerr  
EXECUTIVE DIRECTOR

## **CONTRIBUTORS**

**Michael Irwin**  
Policy Analyst  
New Zealand Business Roundtable  
Wellington

**Roger Kerr**  
Executive Director  
New Zealand Business Roundtable  
Wellington

**Bob Matthew**  
Vice-Chairman  
New Zealand Business Roundtable  
Wellington

**Douglas Myers**  
Chairman  
New Zealand Business Roundtable  
Auckland

**Sir Ronald Trotter**  
Member  
New Zealand Business Roundtable  
Wellington

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## **ECONOMIC DIRECTIONS**



**AUCKLAND REGIONAL CHAMBER OF COMMERCE AND  
INDUSTRY**

**CREDIBILITY PROMISES**

**DOUGLAS MYERS  
CHAIRMAN  
NEW ZEALAND BUSINESS ROUNDTABLE**

**AUCKLAND  
13 MARCH 1997**

## CREDIBILITY PROMISES

President Bill Clinton, it is said, can speak for days without inhaling and is capable of holding sincerely, sometimes for minutes on end, exactly the same views as whatever group he is standing in front of. The columnist Dave Barry has even suggested that if Bill is put in front of a group of trees, given enough time, he will engage in photosynthesis.

Dave Barry's comment reflects the cynicism about contemporary politics that many voters around the world have come to feel. The romance of politics has faded as governments have over-reached their capacity to do good. Faith springs eternal that politicians can make better decisions on behalf of ordinary people than they can themselves, but reality is sinking in with voters. Even President Clinton, a Democrat, has acknowledged that the era of big government is over.

Cynicism about politics in New Zealand seems likely to have gone up a further notch with the Mixed Member Proportional (MMP) election and the wheeling and dealing to form a coalition government which followed it. Those who voted for MMP in the belief that it would put an end to broken political promises have seen promises abandoned by all parties to the coalition negotiations. Those who thought a cloud of pixie dust would descend and transform the behaviour of politicians have seen new levels of rancour and vulgarity in parliament. Pam Corkery has demonstrated an ability to lower its tone single-handedly. After last week's kerfuffle, fisticuffs in the chamber, as in Italy, may not be far away. Welcome to the world of MMP.

None of this should be a matter of any surprise. As the critics of MMP pointed out, it is a system that institutionalises promise-breaking. Moreover, no party now feels an obligation to govern in the interests of the whole community – the name of the MMP game is for a party to pursue its own self-interest. The policies of a party gaining a minor share of the vote can be imposed on the whole community.

What matters is that we draw the right lessons from this experience. One is that if we want less cynicism and disappointment we should rely less on the political process to make decisions on things (like health and education) affecting people's daily lives, and give people more power to make their own choices. Under MMP, voters have less control than ever over politicians. Another lesson is that we should keep MMP under review, and change it if it fails to produce effective government. Thirdly – and this is the theme of my remarks today – we should do everything we can to insist that governing parties deliver on the 'big picture' commitments that they have made to the electorate.

I understand that a new term entered the political vocabulary in the negotiations on the formation of the new government. The term is 'credibility promises', and it refers to those commitments which a party feels bound to adhere to at all costs. For New Zealand First, for example, it seems that 'credibility promises' included scrapping the superannuation surcharge and abandoning the fiscal envelope for treaty settlements.

Whatever one might think of the weight placed by a party on preserving a specific item of policy, that does not constitute the big picture. What is of prime importance is not the particular nuts and bolts of a government's programme but the overall framework. Only a sound, consistent framework, and continuous improvements to it, will allow New Zealand to become a high productivity, high income, and high employment economy. These, rather than specific benefits to the elderly, Maori or other groups, are surely the overriding goals.

Under the coalition agreement the government is committed to maintaining and improving the present economic framework. The document includes commitments to

achieve high sustainable growth rates; a strong, open and internationally competitive economy; more employment and less welfare; and a world-class system of education. These are the kind of goals that really matter for the well-being of the community – they genuinely amount to putting New Zealand's overall interests first. They should, I suggest, be regarded as the core 'credibility promises' which we in the business community and the public at large should hold the coalition parties accountable for achieving.

Of course, some politicians may regard such commitments as glib statements of general purpose which are not meant to be taken seriously as a litmus test of a government's performance. But if we want to restore politics in New Zealand to a more healthy state, we should reject such cynical attitudes. Unless politicians in government back their visions with action, they deserve to maintain their rock-bottom standing in public esteem.

In the case of economic growth, for example, both coalition parties have been quite specific as to their commitments. National is committed to the goal of 3.5–5 percent average annual growth to the year 2010. New Zealand First argued for a faster rise in living standards, and committed itself to a goal of 6 percent growth by the end of its first parliamentary term. These are clear, achievable and measurable goals which we in the business community applaud, and we should insist that the government develops policies to achieve them.

What is the probability of achieving sustainable growth rates at even the bottom of this range on present policies? The answer is close to zero. Economic growth has in fact fallen below 3.5 percent over the past year. In its briefing to the incoming government, the Treasury forecast that on current policy settings growth will average only 3.2 percent over the four years to 2000. The minister of finance recently told a conference of tax specialists that the consensus view in a survey of economists was for an average medium-term growth rate of 3 percent. Given the shortfall from his party's commitment, the question he should have been asked was: 'What are you going to do about it?'. And the question the treasurer should be asked is: 'How are you going to achieve average growth of 6 percent – double the current projected level?'

The government cannot plead that it has committed itself to unrealistic targets. It has inherited a sound economy. The world economic outlook is benign. There is still a large productivity and wealth gap to be bridged between New Zealand and the leading economies. Today policies for improving economic performance are well known and hardly controversial. As argued in the report jointly released this time last year by the New Zealand Business Roundtable and the Auckland and Wellington regional chambers of commerce, New Zealand is certainly capable of moving into the fast lane.

The outcomes of the general election and the coalition negotiations were not bad news from the point of view of improving economic performance. Even though the previous government's campaign was half-hearted and lacked vision, the electorate voted to maintain the economic directions of recent years. The myth that the reforms lack democratic legitimacy has been disposed of. The coalition agreement has preserved the key elements of the economic framework – the Reserve Bank of New Zealand Act 1989, the Fiscal Responsibility Act 1994, the Employment Contracts Act 1991 (ECA) and the open economy.

But the coalition agreement is not good news either. Its worst feature from the perspective of achieving faster growth is the massive projected increase in low quality government spending. Government spending in 1997/98 will be nearly \$3 billion dollars higher than was projected in June 1995, less than two years ago, and a further \$4 billion is scheduled in the following two years. These are enormous sums. We have not seen such fiscal extravagance since the Kirk/Rowling and Muldoon eras. It

has put pressure on monetary policy, discouraged investment and impaired the performance of the export sector which is vital to overall economic growth. It has limited the potential for tax reductions which, as the minister of finance correctly argued at the tax conference, are a positive factor for growth. Ever-increasing government spending was New Zealand's Achilles' heel during the 1970s and 1980s. Despite repeated warnings over the last two years, the government seems determined once again to kill the goose that has been laying the golden eggs.

Thus the government's first decisions as set out in the coalition agreement will do nothing to help achieve its growth objectives – indeed their overall effect will be negative. It follows that in order to keep this most important of its 'credibility promises', further policy instalments are urgently needed. This year's budget is the next opportunity to make significant moves.

There have been some signs that the government realises it has work to do. The treasurer has been stressing the need for tough fiscal decisions, if only to offset new spending commitments. As yet we haven't seen them: last week's Budget Policy Statement revealed that the razor gang rhetoric has so far produced nothing at all by way of spending cuts. Ministers have been assuring the business community that the government has no intention of allowing the economic gains to be eroded. It will have to give the same assurances to international investors – and, more particularly, to back them with action. *The Wall Street Journal* recently noted that the slowdown in economic restructuring in New Zealand will make investors wary, and others have commented that New Zealand now looks less attractive as an investment destination given that other countries are pressing on with economic reforms.

*The Wall Street Journal* spoke of New Zealand's "new wild-card treasurer", but I suggest that judgment is premature. Political reputations are not enhanced by demonstrating economic incompetence. Mr Peters would not have sought the treasurer's position lightly: we must assume he is serious about benchmarking New Zealand's economic performance with that of the Asian tigers and lifting living standards on a sustainable basis. From the time of his maiden speech in parliament, many of Mr Peters' economic instincts have been sound and in tune with free-market thinking. Some of New Zealand First's economic ideas were plainly muddled and, to the party's credit, they were dropped in the coalition negotiations. However, its positions on foreign ownership, privatisation and compulsory savings, as well as government spending, remain obstacles to economic growth. The business community also remains critical of the fact that Mr Peters has still not acknowledged that he wrongly tarnished the image of New Zealand business at large with baseless accusations about improper political influence, as has been confirmed by a court of law. These arguments may continue, but we should go forward with an open mind and assume that Mr Peters sees the goal of achieving 6 percent growth as one of his key 'credibility promises'.

Some parts of the coalition agreement should reinforce that commitment. The 'credibility promise' of achieving a fully open economy, for example, is inconsistent with maintaining import tariffs, as well as maintaining the outmoded producer board controls which affect around 44 percent of New Zealand's total goods exports. Similarly, no one would pretend that New Zealand has a world-class education system: while we have generally ranked high in recent surveys of international competitiveness, we have received a low score for education. The commitments in these areas are welcome. So too is the obvious intention to curb the judicial activism of the courts in administering the ECA and making it more difficult for firms to create jobs.

Other parts of the coalition document, however, reflect confused thinking and pandering to special interest lobbies which collectively put at risk the broader vision. For example, the coalition parties are committed to delivering energy "at the lowest cost to the community as a whole". Given this goal it is quite bizarre that the first

three "key initiatives" proposed to achieve it are no privatisation of the Electricity Corporation of New Zealand, no privatisation of Contact Energy and no privatisation of Transpower. There is now overwhelming evidence that private ownership serves consumers' interests best. Countries from Poland to Argentina are privatising their electricity industries, and New Zealand will shortly be one of the few countries left with a predominantly state-run system. The business community must challenge the ideological commitment to state ownership in this and other industries. The question to ask is: 'Where is the hard data and analysis that has led the government to take a different view on electricity privatisation from practically every other government around the world?'

Similarly in education, health and accident compensation, the document shows no recognition that the core problems stem from the dominant role of the state as a provider of services and the lack of competition and consumer choice. Sooner or later people will surely realise the connection between the widespread dissatisfaction with these services and the fact that they are now provided on a different basis from almost every other service in the economy. In education and health we have moved some distance towards decentralisation, but it is an unsatisfactory 'half-way house', with many tensions still pulling the systems back towards the centre. To borrow a phrase from Abraham Lincoln, a system that is half free and half slave cannot endure, and Lincoln did not believe the answer was slavery. In all these areas we need to move towards genuine market systems of provision, with the government concentrating on its regulatory and financing roles where necessary.

On a brighter note, there are some indications that the coalition is concerned about the problems of welfare dependency and may be prepared to get serious about them. Interestingly, the impetus in this area seems to be coming from New Zealand First, which understands the damage state welfare has done to many Maori families, and politicians like Arthur Anae whose outstanding maiden speech was about the desire of Polynesians for work, not welfare. Work-for-the-dole schemes are not the right answer, but the underlying idea that beneficiaries receiving help have a reciprocal obligation to become self-supporting as quickly as possible is certainly sound. This is an area where the community at large – including voluntary organisations, churches and the business sector – must, in my view, assume greater responsibilities because of the real limitations of state welfare. The visit this week by Sister Connie Driscoll is intended to stimulate debate about more effective approaches.

It must be hoped that New Zealand First brings other fresh thinking to the coalition government. One of the main criticisms of the National party during the election was that it had run out of ideas. It does not yet seem to have come to grips with this problem – senior ministers speak openly of 'muddling through'. Muddling through was what characterised the National party under Holyoake, and it cost the country enormously in terms of years of lost opportunities. Politicians who speak or think of 'muddling through' ought to ask themselves why they are in politics and what genuine political leadership consists of.

Politics under MMP is likely to become more fluid, and business should take an interest in the policies of all political parties. It should not play favourites. The new environment allows business more latitude to be both critical and supportive of all parties' policies according to their merits. Recently the Business Roundtable published a report explaining why the Alliance's proposed financial transactions tax was a bad idea. However, we agree with the Alliance that appeals to the Privy Council should not be abolished and it is pleasing that this view has prevailed, despite the prime minister telling us two years ago that opposition to it was a waste of time. Similarly, we believe that many of ACT's policies are sound and innovative and would improve New Zealand's economic and social performance, but compulsory superannuation is not one of them and we haven't hesitated to say so.

For its part, Labour largely wasted the two terms it has so far spent in opposition and has failed to update itself as a political party. It was astonishing to see Labour conferring with the Council of Trade Unions during the coalition negotiations in a way that no other party did with outside interest groups. Labour must surely detach itself from its old trade union links, and with vested interests in the health and education sectors, if it is to present itself as a party capable of governing in the interests of the whole community. In education, for example, social democratic administrations from Sweden to America are promoting alternatives to state schooling: why would anyone expect New Zealand education, a sector controlled by unions, to work any better than our ports or meat industry did under union domination in the past? Labour, of all parties, should be on the side of parents and children, not the unions. The attitude of too many teacher unionists is summed up by the remark of Al Shanker, the most prominent teacher unionist in the United States: "When the kids start paying union dues, that's when we'll start looking out for their interest."

Labour should also accept the reality of the ECA. The ECA has brought enormous benefits to workers, firms and the unemployed, and under MMP it is unlikely that there will ever be a parliamentary majority capable of overturning it. Similarly, Labour must review its commitment to big government, and to high spending and taxing policies. As Chris Patton, the outgoing governor of Hong Kong, said recently:

It defies reason and experience to pretend that public spending and tax levels have nothing to do with Asian success or European problems.

The directions in which Bill Clinton has been moving in the United States and Tony Blair in the United Kingdom surely point the way if Labour is to become a modern and viable political force. If Labour seriously re-examined how best to achieve some of its traditional goals, I see no reason why it would not find much common ground with the policies of other parties, including ACT. In the past Labour has been the party of new ideas: sadly, it has become backward-looking and is not challenging the country's thinking.

When I spoke to this audience last November I ended by saying that we have come an enormous distance as a country in a few short years, and that MMP must mean much more progress or New Zealand will fall behind again. Those who point to the fact that some people are still struggling must accept that they won't be helped by governments that just sit on their hands. People may have a heart of gold but so does a hard-boiled egg – it is sound thinking and actions, not sentiments, that count.

Leaving aside a few lost souls in the universities and churches, there is now little debate about what constitutes sound economic policies. From recent testimony by Alan Greenspan to remarks by John Howard to the forthcoming visit of Chancellor Kohl, the international respect for our economic reforms continues to be confirmed. Clearly the way forward is for governments to pursue policies that deepen and widen them. The successful countries of Asia are recording growth rates in the range targeted by the coalition partners, not by state intervention but by strengthening their sound economic fundamentals: maintaining low inflation, keeping tax rates low, avoiding large welfare states, maintaining free labour markets and therefore low levels of unemployment, pressing on with privatisation and deregulation, and making greater use of markets and the private sector in delivering health and education. New Zealand has been doing the right things, but there are many more nettles to be grasped if we are to continue moving forward.

The business sector has been speaking with virtually one voice about the steps it wants the new government to take. It has stressed the need to maintain price stability, and the unnecessary widening of the Reserve Bank's target range may at least have the merit of demonstrating that it was an exercise in trivial pursuit and that the real problems lie elsewhere. Chief of these is the growth of government spending.

Leaving aside a few dinosaurs, the business sector almost unanimously rejected proposals to spend an extra \$100 million on so-called business assistance. Gil Simpson told the recent government-business forum that there should be a Government Help Act which would allow any of us to sue a government which attempts or threatens to help our businesses with edicts or largesse. I doubt whether many business people or organisations anywhere else in the world would take such disinterested stands.

Instead, business representatives have rightly argued that the strong fiscal position should be maintained and applied to reducing debt and tax rates. It should be possible in the next few years to substantially reduce personal and company income tax rates, down towards Asian levels of 20 percent or below. There is no logic in tying tax reductions to the outcome of the referendum on compulsory superannuation. All the evidence indicates that compulsory saving schemes do little or nothing to boost overall national savings, but merely alter its pattern. As Australia's experience with a large balance of payments deficit shows, there is no reason to believe that a compulsory savings scheme displaces foreign investment even if it made sense to do so, which of course it doesn't. From a macroeconomic perspective, a medium-term programme of tax reductions can be managed with or without a compulsory savings scheme, provided government spending is controlled, and should be pursued as a goal in its own right.

If the business sector continues to put forward sound policy ideas in a principled way, and to criticise unsound ones, I believe it will be listened to. We must also accept the responsibility to pursue continuous improvement and innovation in all our enterprises. Only by doing so will we create the growth that raises living standards.

But perhaps the most important contribution business can make in the current environment is to challenge political parties to raise their sights. At the last meeting of the Business Roundtable, the head of the Education Review Office told us of her shock at discovering a school with an item on its notice board: 'Lower your expectations and avoid disappointment'. Contrary to what the teacher unions tell us, this attachment to mediocrity rather than excellence characterises too much of our education system. But it has also come to characterise our political system as well, following the years of leadership associated with Roger Douglas and Ruth Richardson. Business must make it its business to see that a strategy of 'muddling through' is rejected.

We should therefore commit ourselves, I suggest, to insisting that the big picture 'credibility promises' of the coalition parties are kept. New Zealand needs strong, sustainable economic growth if it is to achieve economic prosperity and security. The policies needed to achieve such goals are being advocated by all of the government's main economic advisers. However, they are not being adopted: all international observers are saying that we have gone off the boil, and investors are reducing their exposures to New Zealand. We are just drifting again, as we did in the Holyoake years. The time for a wake-up call is now, not in 10 years' time when we realise another raft of countries has passed us by.

We need a new sense of urgency and commitment to improve the business environment and attack social problems, and we need it now. I suggest that business organisations should keep a six-monthly scorecard on whether the necessary policies are being put in place, and they should highlight shortcomings. Government expenditure trends and the growth outlook should be a particular focus. If this causes some tensions with the government or with vested interests that would be affected by change, so be it. Those who make credibility promises to the electorate should be held accountable for delivering on them.

**COMMITTEE FOR ECONOMIC DEVELOPMENT OF  
AUSTRALIA**

**RETREAT FROM REFORM  
ARE AUSTRALIA AND NEW ZEALAND  
BECOMING LAGGARDS AGAIN?**

**BOB MATTHEW  
VICE-CHAIRMAN  
NEW ZEALAND BUSINESS ROUNDTABLE**

**SYDNEY  
29 APRIL 1997**



## RETREAT FROM REFORM: ARE AUSTRALIA AND NEW ZEALAND BECOMING LAGGARDS AGAIN?

In my capacity as chairman of Air New Zealand, I suppose I should be grateful that one of New Zealand's growth industries in recent years has been hosting an array of visiting Australian politicians, business leaders, industry association executives, journalists and others, all keen to study New Zealand's economic reforms and their possible application in Australia.

It is therefore with a sense of disappointment that I have to tell you New Zealand is showing signs of losing the plot. For some time now we have been drifting back into the comfort zone that led the then prime minister David Lange to call for the infamous teabreak in 1988, and Jim Bolger to sack Ruth Richardson as finance minister after the 1993 election. As yet, there is no sign that our new Mixed Member Proportional (MMP) electoral system stands for 'Much More Progress', as it needs to do. This isn't just a personal or business view: a recent poll indicated that for the first time in four years more people think the country is on the wrong track than the right track. So I caution any would-be Australian traveller to New Zealand not to expect a lot of inspiration from our recent record or from our current agenda for further change.

Moreover, the business communities in both countries need to recognise that neither Australia nor New Zealand should serve as the economic reform benchmark for the other. Sure, we can identify various areas where New Zealand is ahead of Australia, and vice versa. But both countries are lagging behind the more dynamic regions to our north (and elsewhere), and that's what matters. If there's one thing neither of us can afford it's complacency – a belief that all the main reform tasks have been completed or, worse, that some are simply too hard to be contemplated.

Genuine political leadership, of the type exhibited in New Zealand by Roger Douglas and Ruth Richardson, is, regrettably, comparatively rare. When it exists, it needs to be nurtured and encouraged. When it doesn't, business has a duty to do its bit to fill the void. That's how the New Zealand Business Roundtable sees its role, and I think it can claim to have played a significant part in New Zealand's achievements over the past decade or so. Often this involved rejecting calls from politicians and special interest groups to accept the status quo.

The crucial task of business in public policy debate must be to lift the sights of politicians and the general community – to raise expectations, not lower them. Business must draw on its experience and summon the courage to challenge what is often seen as unthinkable or politically impossible, and explain what can be achieved if our countries adopt sound policies. It must also point out the inevitable consequences, in a fast-moving, global economy, if we don't. As the deputy-secretary of the US Treasury has recently reminded us:

One of the most foolish things said about the international economy these days is that because capital moves so quickly and so freely, government policies have little influence. In reality, precisely because of greatly increased capital mobility, the difference between having the right and wrong government policies has never been greater... . And just as good policies are rewarded as never before, mistaken policies are punished more severely.

There are already signs that financial markets are revising downwards their assessment of New Zealand's prospects in the light of the coalition government agreement and the policy actions – and inaction – of recent months. For example, economic commentators have reported that the widening of the Reserve Bank's target range for inflation (from 0–2 percent to 0–3 percent) has increased nominal long-term bond yields by the expected half a percentage point relative to the yield on inflation-

indexed bonds. The government has not explained why it wanted to raise the cost of borrowing for all New Zealand firms and households. A couple of years ago, long-term interest rates in New Zealand were over one percentage point lower than in Australia. Now we have lost that advantage.

Steve Hanke, professor of applied economics at Johns Hopkins University and president of Toronto Trust-Argentina, recently commented in New Zealand that the target range decision sent out "dangerous signals" to international investors. There have been other indications of a general softening of economic resolve. The government plans to increase spending by \$5 billion over the next three years, much of it in low quality and badly targeted ways. The additional spending commitments have led the governor of the Reserve Bank, Don Brash, to warn that this "fiscal expansion", equal to about 5 percent of gross domestic product (GDP), will "dominate the picture for the path of the economy."

Financial markets are reacting to these developments – just as the economic policy meddlers in the early days of the Mitterand government, or more recently in Mexico, found to their great cost. The prospects of New Zealand regaining a triple A credit rating are receding and, unless there is a quick return to economic rectitude, New Zealanders will learn how easily the hard-won gains of recent years can be frittered away, with nothing to show in exchange.

A couple of weeks ago, the *Australian Financial Review* noted in an editorial that the new government has:

... produced a slippage of New Zealand's economic policy performance ... . It is not pushing reform into the remaining closeted parts of the economy, including electricity infrastructure, agricultural marketing boards and the sizable welfare state remnants. As a result, New Zealand's business prospects have dulled.

The treasurer and leader of New Zealand First, Winston Peters, strenuously denied this charge. He said:

There will be no pause in the reform process ... . This government is committed to reforming all sectors, and no particular group is above that process ... . On numerous occasions ministers have indicated New Zealand can expect a radical shake-up of the welfare state in the budget.

While this response is encouraging as far as it goes, ultimately it is actions rather than words that count. Last week's positive decision to deregulate postal services may be a sign that the government recognises the need to make up for lost time on microeconomic reform. It needs to be vigorously followed through. Accordingly we await the new treasurer's first budget in a couple of months' time with great interest.

The requirements for New Zealand from here on are clear enough. They were enunciated last year in a report, *Moving into the Fast Lane*, published by the Business Roundtable in conjunction with the Auckland and Wellington chambers of commerce. The list included:

- reductions in government expenditure, which still accounts for a third of national income;
- privatisation of remaining state-owned enterprises and more competition in their product markets. The government has failed to offer any argument or evidence to justify its opposition to privatisation of, for example, its electricity, television, postal service and accident insurance businesses;

- reductions in high tax rates on business and personal income. It should be possible in the next few years to get all income tax rates down to 20 percent or below;
- improved efficiency in local governments and divestment of their businesses;
- deregulation of agricultural marketing boards, which still control about 44 percent of New Zealand's total goods exports. Australia has made much more progress in introducing competition into agricultural marketing and in changing cooperative organisations into more efficient and accountable corporate structures;
- the introduction of competition and private delivery into accident compensation;
- stronger obligations on beneficiaries to seek and accept work where they are in a position to do so; and
- direct funding of public and private schools on an equal basis, and the abolition of centralised teacher employment arrangements.

It is no coincidence that education and health are today the main subjects of public dissatisfaction in New Zealand. They are services which are dominated by government providers, sheltered from competition and – particularly in the case of education – run by unions. Education, in other words, operates in an environment much like our waterfront in the past. Why should anyone be surprised it is not delivering satisfactory results?

Clearly the problem is not simply one of resources. New Zealand spends 6 percent of GDP on education compared with 4.9 percent in Australia, yet Australia scores well above New Zealand in international comparisons of education performance. A recent international study of the achievement levels of 13-year-olds in maths and science ranked New Zealand just above average out of 41 countries, at 24th place for maths and 22nd for science, whereas Australia ranked at 16th and 12th place respectively. One likely explanation is that there is more competition in Australian education, with 30 percent of children enrolled in non-government schools which receive higher per pupil government funding on average than in New Zealand. Others would argue that New Zealand has gone much further in 'dumbing down' its curriculum. I know that David Kemp, Federal minister responsible for schools, and many in the business community are nevertheless very concerned about school performance in Australia, and I understand with good reason. New Zealand has cause to be far more concerned.

It is perhaps worth mentioning to an Australian business audience just how consistent and broadly based New Zealand business opinion has become. After surveying a sizable number of business leaders, the editor of a business magazine recently observed that:

... despite cries in the daily press for some help in the face of New Zealand's strong dollar, not one of the business leaders I spoke to was in favour of intervention. As Richard Blundell of Fisher and Paykel put it, "Over time a strong dollar is good for us all ... ". His immediate response to the problem was to focus on boosting production. Even smaller companies are inclined to face the strengthening dollar head on ... [There are] few whinges and pleas for government intervention. Instead, these organisations are all getting on with it – heads down, working flat-out, innovating and growing.

And to underline the extent of support for an open economy, you might be interested in this statement by the Apparel and Textile Federation of New Zealand, following a presentation to a group of cabinet ministers:

Despite the high value of our dollar favouring imports, our exports have gone up nearly 400 percent since 1988 ... . We face competition internationally on a pretty roughed up and unlevel playing field with high tariffs and non-tariff barriers in other markets. An example [is] Australia whose industry is generously assisted through their export credit scheme and overseas assembly provisions ... . But we're not asking for any special consideration. What we want from our government is that they know more about what our industry contributes to our economy and workforce.

Protectionist sentiment is virtually dead in New Zealand. There has been no debate about protection in the Business Roundtable for years, and our Manufacturers Federation is now also a free trade organisation. A final review of tariffs is set down for 1998 and the only issue is whether the remaining relatively low tariffs will be phased out over perhaps five years, or sooner. Recently all the major business organisations said 'thanks, but no thanks' to proposals by the coalition government to spend \$100 million on various forms of business assistance. They gave priority to sound economic fundamentals, including expenditure discipline and lower taxes.

The attitudes prevailing today in New Zealand's business community would have been unthinkable 15 years ago when the country still had extensive import licensing and couldn't contemplate life without it. Businesses lobbied for short-term and self-interested policies and reaped the consequences: a third-rate economy. Over the past decade, New Zealand business people have increasingly been prepared to advocate – and adhere to – a broad national interest perspective, based on the belief that only what is good for New Zealand is good for business in the longer run.

An approach to public policy based on similar long-term and economy-wide perspectives does not seem to have taken root to the same extent in Australia. I think that is a great pity. Too many Australian business people and their organisations seem to operate under the mistaken belief that governments can repeal the laws of supply and demand, or that a favour granted to one group somehow doesn't have to be paid for by someone else. For example, I noticed that no less an organisation than the Australian Chamber of Commerce and Industry recently passed a resolution stating that:

The scheduling of any further cuts in the level of protection must be part of a wider package of comprehensive domestic reform ... and, in terms of external trade, improved market access. The revenue implications of any measures that may be implemented need to be accounted for, and alternative revenue sources or expenditure cuts be identified ... . Full account should be taken of the economic, strategic and social impacts.

With codewords of that kind and the talk about 'reciprocity', it's sad to see some elements in Australian business hoisting the white flag on trade liberalisation.

Business in New Zealand is becoming exceedingly frustrated at the lack of government action over the last three or four years to build on our hard-won economic success. We want to see a much faster rise in living standards, a return to full employment, and more effective strategies to deal with social problems such as welfare dependency. If we in business can help revive the achievement orientation that drove the earlier reforms, I have no doubt that politicians will sooner or later be obliged to take notice.

By contrast, I find it hard to comprehend just how acquiescent some business leaders seem to be in Australia at the Federal government's as yet rather uninspiring rate of progress on economic reform – and at the even faster retreat from sensible policies on the part of the opposition. Perhaps they still cower in fear of the kind of retribution and verbal mauling that prime minister Paul Keating was wont to dish out to his critics. But if the business community will not stand up and be counted, who will?

The extent of the present drift in New Zealand reminds many in business of the Holyoake years – five terms in the 1960s and early 1970s when the economy appeared to perform moderately well, but when we failed to tackle underlying problems and let them build up to crisis levels. The equivalent era of drift and missed opportunities in Australia was, of course, the Fraser years. I know the present Federal government is determined not to be a Fraser government look-alike. Yet as I see it from a New Zealand perspective and from my several business exposures to Australia, there are risks of similar tendencies developing. Let me cite three examples.

First, notwithstanding the difficulty with the numbers in the senate, the Workplace Agreements Act 1996 falls well short of enabling genuine labour market flexibility, with employers and employees free to contract without third party meddling. I hope firms are making what progress they can under the new rules and that someone is already working on the next wave of labour market reform, given the great economic and job creation benefits a freer environment offers.

It is hard to exaggerate the difference which the Employment Contracts Act 1991 has made in New Zealand over the past six years. The confrontational, strike-prone, inflexible industrial relations regime which we once shared with Australia has been replaced by a system in which, to a far greater extent, workers and management work to a common goal. Since the Act came in, output has gone up by 20 percent, around quarter of a million additional jobs have been created, and the unemployment rate has fallen from 10.9 percent in September 1991 to 5.9 percent today, with the long-term unemployment rate falling fastest. The Business Roundtable believes full employment could be achieved in New Zealand by the year 2000, particularly if the government put the interests of the unemployed ahead of the interests of the jobs of our Employment Court judges, who are the main obstacles to realising that goal.

Secondly, the forthcoming decisions on reductions in tariffs on Australia's most highly protected industries will be a watershed. They will signal whether the government cares mainly about consumer interests and overall economic efficiency, or whether it is vulnerable to lobbying by producer interests at the expense of the wider community. People in many other industries will be closely watching the outcome, and to date the messages emanating from ministers on the subject do not seem particularly reassuring.

Thirdly, another litmus test of the government's resolve is the waterfront – an area which New Zealand fixed up in the late 1980s, several years after Australia started talking about the need for reform and holding inquiries to work out what to do. I hope I am wrong, but there have been some suggestions that the government might find waterfront reform too difficult, and that some in the business community are scared stiff of any industrial disruption associated with it. If such views are gaining currency, I hope politicians and the business community will think again. Nothing more symbolises economic mediocrity than a high cost, inefficient waterfront. Nothing is more visible and discouraging to overseas trading partners and potential investors. And nothing would make the remaining elements of the reform task seem easier than success on the waterfront. So I urge business to recommit itself to the task of ensuring that effective and durable waterfront reform occurs soon.

I hope you will permit me briefly to put on my hat as chairman of Brierley Investments Limited (BIL) and Air New Zealand and comment on one or two matters close to our corporate hearts.

BIL made its first equity investment in Australia in 1964. We now have several substantial investments here, including 28 percent of James Hardie, 7.4 percent of Coles Myer and 20 percent of John Fairfax. In addition, Air New Zealand – in which BIL is a 42 percent shareholder – now owns 50 percent of Ansett. BIL also has investments in other New Zealand-based companies which have significant involvements in Australia, such as the Sealord Group, New Zealand's largest deep sea

fishing company, the Union Shipping Group, and Tasman Agriculture, which recently embarked upon a major rural acquisition and redevelopment in Tasmania. Today BIL has about \$1.8 billion invested in Australia, slightly more than the \$1.6 billion it presently has invested in New Zealand.

What happens in Australia is therefore of more than passing interest to BIL. We are keenly aware of a number of regulatory constraints in Australia, such as those affecting takeovers, taxation, media ownership and aviation policy.

The Australian takeovers code has a restrictive regime with a 20 percent threshold. It is now widely accepted that takeover regulation works against shareholders' interests by protecting poorly performing boards and managements, and inhibiting industry reorganisation. New Zealand governments have rightly resisted pressures to apply 'Aussie rules' in this area. The New Zealand Stock Exchange has established a range of options in its listing rules and despite the near hysteria of a few self-appointed shareholder advocates a few years ago, shareholder voting has been uncontentious and overwhelmingly in favour of the less restrictive options. There is a case for reviewing both the listing rules and New Zealand's statutory regime to further liberalise some provisions. It is to be hoped that the current review of the Australian corporations law will revisit this issue, by reviewing the fundamental principles rather than simply tampering with the present regime.

The taxation rules of Australia and New Zealand bias decisions as between outward and inward foreign investment and different forms of domestic investment. While New Zealand is probably further down the track than Australia in examining its international taxation regime, both countries have a long way to go to develop a sound and comprehensive framework which recognises that our economies are now fully integrated into the global economy. As I see it, Australia also badly needs wider tax reforms, including a broader and more robust revenue base.

Australia's foreign investment policy in areas like real estate, banking, civil aviation, shipping, media and telecommunications is also much more restrictive than New Zealand's, and in all cases the interests of consumers are compromised for dubious 'national interest' reasons. On aviation, New Zealand remains keen to move to a genuine single aviation market and 'open skies' policy, which I might add was conceptually the brainchild of the Keating government - not New Zealand. As things have turned out, Australia has been a reluctant partner since Paul Keating intervened to raise the sale price and protect the perceived interests of Qantas a few years ago. The ongoing procrastination about giving effect to the single market has always been geared to Qantas's interests, rather than those of tourism or the travelling public.

There is a similar case for liberalising media industry regulation. Many governments have treated the media industry, both print and electronic, differently from other sectors of economic activity. Underlying this approach was a perception of the capacity of the various media to shape collective views, values and culture.

New Zealand was at the forefront in recognising that this stance no longer has validity (if it ever did) in an era of global communications networks. Our relatively isolated media markets were opened to overseas investment. Other countries have followed suit as they have come to recognise that foreign investment in media does not lead to subversion of national culture. Indeed Rupert Murdoch's foray into the Asia-Pacific market through Star TV is proving the opposite to be true. Appropriate local material is being demanded by consumers, and if it is not provided the service will be ignored.

In APEC Australia and New Zealand are arguing for liberalisation of trade and investment between neighbour countries. Under our Closer Economic Relations (CER) agreement, Australia and New Zealand have effectively tied the knot of open trade and economic interdependence. The time has come to treat trade in services

such as aviation, media and communications in a similar way to trade in goods. The time has also come for our investment market to be treated as one.

I spoke at the outset about the comparative rarity of genuine political leadership. Jeff Kennett has taken over the mantle from Roger Douglas and Ruth Richardson in this part of the world. Some of Victoria's initiatives in the sporting arena and the poaching of a Bledisloe Cup rugby test match to the Melbourne Cricket Ground have been quite audacious. For my part, there is a very important lesson from the Victorian election last year – namely that, as was the case with earlier New Zealand elections, political fortune favours the brave. The days are long since gone when the standard answer to the question 'what is the capital of Victoria?' was 'about two dollars'. The Victorian government's drive to improve its economy shows no sign of letting up. Along with other governments in Australia, it is forging ahead with privatisation initiatives at a time when privatisation in New Zealand has virtually come to a standstill. The lessons about political leadership and the payoffs of bold reform risk being overlooked in New Zealand: we badly need a Jeff Kennett right now.

It is in New Zealand's interests for the Australian economy to perform better, and vice versa. Each is a very important market and investment destination for the other. Australia enjoys great natural advantages, and it did not mismanage its affairs as badly as New Zealand in earlier years, but it has nevertheless squandered many opportunities. New Zealand is a smaller and less robust economy and will soon lose its attractiveness to investors if it fails to maintain a margin of excellence over competing economies. Neither of us can afford to flag, but New Zealand in particular has to stand out from the pack.

May I conclude by summarising eight principles for economic reform which have guided the activities of the Business Roundtable over the past decade. They are:

- never allow special interests to dominate wider community interests;
- always focus on the medium term, not just the short term;
- always recognise the central role of competitive markets in creating wealth;
- accept the need to be open to international competition and international influences;
- treat the labour market no differently from any other market;
- apply the same principles to reform of the public sector as are applied to the private sector;
- acknowledge that while market failure exists, so does government failure, and when the government fails the consequences are often far-reaching; and
- when redistributing income, do it directly and in a transparent manner.

If these principles are followed faithfully, there is no reason why either Australia or New Zealand should be laggards and every reason why they can become top performers. But we should not kid ourselves that these achievements will be possible without the constant involvement by business organisations and individual business leaders in helping to inform the community at large of the nature of the task and keeping governments up to the mark. I hope the Committee for Economic Development of Australia (CEDA) and its membership will commit itself to that endeavour.

**OTAGO CHAMBER OF COMMERCE AND INDUSTRY**

**DEMOCRACY AND ECONOMIC REFORM**

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

**DUNEDIN  
10 DECEMBER 1996**



# DEMOCRACY AND ECONOMIC REFORM

## Introduction

In *Rolling Back the State*, Jane Kelsey, a non-stop critic of New Zealand's recent economic reforms, wrote:

Disengaging the state from the economy, unmaking welfare democracy and reallocating state power was an immense and contradictory undertaking. ... Democratic processes were a major hindrance. Power had to be exercised quickly, decisively, consistently, and as free from public scrutiny as possible. The inevitable casualties were parliamentary process, participatory democracy and executive accountability. ...

Parliament became largely irrelevant. The state bureaucracy took over as the leading actor and the principal source of policy, in collaboration with the political executive. ... Virtually all notion of conventional restraint disappeared. ... Many of the public perceived 'a radical decline in representative democracy and its political liberties and the concomitant extension of authoritarian control over all spheres of social relations'.<sup>1</sup>

According to Kelsey, now an associate professor of law at the University of Auckland, these observations describe "accurately the process of government in New Zealand over the past decade" and demonstrate "the intrinsically anti-democratic nature of the liberal revival."<sup>2</sup> A few paragraphs later she asserts that "The liberal reforms were profoundly anti-democratic".<sup>3</sup> Kelsey goes even further in *The New Zealand Experiment* where she describes New Zealand's recent governments as "undemocratic".<sup>4</sup> A similar claim has been made by a number of other critics of the reforms such as columnists Chris Trotter and Bruce Jesson and the producers of the documentary *Someone Else's Country*.

What is one to make of such claims? The first thing to be said is that New Zealand is a fully-fledged liberal democracy, as that term is normally understood. Universal adult suffrage embodies equality of political rights. Regular elections give voters the opportunity to judge the government's performance and to confirm it in office or replace it. Since freedom of political association is assured, individuals may seek to stand for an established political party or set up a new party. And since New Zealand has one of the least corrupt systems of government in the world, citizens can be confident that the results of elections are fair.

In this elementary sense, the reforms implemented by successive governments over the last dozen years are legitimate and enjoy democratic sanction. The 1987 election, in which Labour was returned to office with an increased majority although it had initiated painful reforms, provided an unequivocal endorsement of its stewardship. When Labour lost its way, National was elected in 1990 with a mandate to reform the labour market and curb government spending, and was re-elected in 1993 despite its unpopularity in many quarters. And the outcome of the recent election under a new electoral system was a further ratification of the general thrust of the economic policies of the past 12 years. More specifically, the key policies that are necessary for

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<sup>1</sup> Kelsey, Jane (1993), *Rolling Back the State: Privatisation of Power in Aotearoa/New Zealand*, Bridget Williams Books, Wellington, pp. 129-130.

<sup>2</sup> *ibid.* p. 130.

<sup>3</sup> *ibid.* p. 131.

<sup>4</sup> Kelsey, Jane (1995), *The New Zealand Experiment: A World Model for Structural Adjustment?*, Bridget Williams Books, Wellington, p. 297.

continued economic success were overwhelmingly supported by the electorate, as the Manufacturers Federation correctly observed:

- Retaining our flexible, enterprise-based employment relations system – National, New Zealand First, ACT, United (60% of parliament);
- No further tariffs or obstacles to trade or investment to be introduced – National, Labour, ACT, United (75% of parliament);
- Reducing the overall level of taxes – National, New Zealand First, ACT, United (60% of parliament);
- Maintaining low inflation and retaining the Reserve Bank Act – National, Labour, Act, United (75% of parliament).<sup>5</sup>

The only significant party pledged to reversing the reforms – the Alliance – lost the most ground among the voters. This result appears to have devastated Trotter and many Alliance supporters. They appear unwilling to acknowledge that excessive government, including state ownership and control of private activities, is on the endangered list in many countries, and for good reason. The successive decisions of the electorate clearly give the reforms democratic legitimacy, even though defects such as a number of broken political promises were apparent in their execution. Kelsey's view of the process belongs in the realm of fantasy.

### Democracy and Reality

The case for economic reform is commonly presented without direct reference to democracy, or indeed to politics generally. That doesn't mean that economic reform is undemocratic, but it does mean that the connection between reform and democracy is a subtle one that can be misunderstood. It is vital for the success and continuity of New Zealand's economic reforms that the present policy settings are understood and supported by the electorate.

Democracy is not a form of magic whereby whatever the people want can be quickly brought into being. Yet participants in public debate often speak as if they believe that the only obstacles to the full realisation of the 'will of the people' are sinister human forces, whose influence could be removed if only we could summon up the determination to do so. Hence the readiness to blame perceived demons like 'multinational corporations', 'the New Right', and so on (the different bogeymen move into and out of fashion over time). The Kelsey-type view fails to accept that economic progress always involves change and dislocation, often painful in nature, and sees such dislocation as evidence of a conspiracy. But reality is actually less malleable than those with an unconstrained vision of the world would wish: it is the outcome of a vast range of factors, including the *unintended* and *unforeseen* consequences of human actions. It cannot be changed by wishful thinking. The reality of a situation has to be accepted and understood, and the best way of addressing it worked out.

Take the foreign exchange crisis that developed in the lead-up to the 1984 election as an example. The country was close to bankruptcy, in the sense of being unable to service its debts. Imminent bankruptcy cannot be legislated away by a democratic vote. But it can be addressed. The worst way is to repudiate the debt. That could be done, lawfully and 'democratically', but the cost would be huge. Imports of goods and services would fall, the country would face high interest rates for many years and foreign investment would dry up, with catastrophic effects on living standards. Some New Zealand politicians actually entertained repudiating foreign debt. An alternative response is to implement policies that restore confidence and allow the government to

<sup>5</sup> "Coalition Building Must Respect the Wishes of the Electorate", media release, New Zealand Manufacturers Federation, 12 October 1996.

sell new debt to fund its commitments. That response, in turn, can be adopted as an explicit policy decision, or it can be imposed by the independent judgments of millions of resident and offshore investors, or as a condition of receiving assistance from the International Monetary Fund (IMF). In New Zealand, it was done as a policy decision: the new government devalued the dollar and implemented other corrective policies. New Zealand's autonomy was preserved, and the change of policy direction was fully legitimate.

The reform process began as a response to an inescapable economic reality. It was better that it was undertaken by New Zealand on its own behalf, and in a way that preserved both the legitimacy of the political system and the country's long-term economic prospects, than imposed from the outside with all the risks to political and economic stability that that would entail. To pretend that there was some other, 'democratic', response is to fall for the childish belief that governments can exercise quasi-magical powers to change reality simply by wishing to do so.

From a democratic perspective, the most objectionable aspect of the foreign exchange crisis was the decision of the Muldoon government to conceal the true financial state of the country from the electorate. If a company's directors were to raise capital on the basis of a prospectus that misrepresented its financial state, they would rightly face serious charges. The incoming Labour government of 1984 cannot be held to have acted undemocratically in changing its election manifesto when it was found to be incompatible with the parlous situation that it discovered. In contrast to Kelsey's mistaken analysis, subsequent measures such as the Public Finance Act 1989, the State Sector Act 1988, the Fiscal Responsibility Act 1994 and greater transparency in government generally have increased information available to electors and strengthened our democratic arrangements.

### Democracy and Other Values

In a free and open society like New Zealand, democracy is a fundamental attribute. But as well as valuing equal political rights and the power to throw a government out, we also value the rule of law and individual rights. These are usually compatible with democracy, but they may not be. Democratic assemblies have voted to discriminate against minorities and to deprive them of basic civil rights. Many democracies have, therefore, adopted institutional arrangements which, together with legal constitutions, an independent judiciary, a free press and inbuilt moral restraints, offer some protection for minorities and individuals against tyrannical majorities.

More of a problem nowadays, however, is the undermining of the rule of law by the delegation of executive powers to agencies remote from parliamentary decision making (such as the Human Rights Commission), restrictions on the right of competent parties to make mutually beneficial contracts, and the granting of privileges to minorities that come at the expense of the majority. One of the achievements of the Employment Contracts Act 1991 (ECA) was to end what Chris Trotter has called the "economic democracy" of trade union members. Under this "economic democracy", trade union membership was compulsory and unions were allowed to impose on employers conditions whose costs were passed on to the community as a whole. Now individual workers are freer to make their own arrangements, including using trade unions as bargaining agents. In other words, an end to Trotter's version of "economic democracy" has helped protect the community from the harm done by inefficient workplace practices, as well as enhanced individual workers' rights. That surely is a gain.

When people such as Kelsey complain that an otherwise legitimate and constitutional decision is 'undemocratic', they usually mean that they oppose it, and are claiming that 'the people' support their view. Sometimes that claim may be correct, but the popularity of ideas does not make them sound, and vice versa. Galileo was initially on his own in claiming that the earth went around the sun, and Muldoon was

undoubtedly right to claim that his disastrous policies enjoyed popular support. Privatisation is an unpopular policy in some countries despite its soundness, just as nationalisation was once a popular idea. The death penalty for murderers often receives majority support in opinion polls around the world, but opponents of the death penalty advance principled arguments against it. Counting heads is no substitute for pursuing scientific truth and sound policies. It would be very strange if that were not the case. To favour whatever the majority favours means having no views of your own and would provide no protection to minorities.

This point brings out the limitations on the scope of collective, political decision making: some things are appropriate to be decided by government, others not. The private sphere of life – markets and voluntary activities – does not require conformity, whereas majoritarian politics does. Kelsey and Trotter would like to give politics a far greater role than I would. A free society and a market economy are superior to the socialist alternative because by minimising the writ of politics they create a more effective form of democracy for enabling all people – ordinary people as well as political people – to make decisions about their own lives.

### **Democracy: Limited or Unlimited?**

Economic reform, as that term is used nowadays, often means scaling back industry-specific government interventions in favour of market decision making, on the grounds that such interventions fail, or at least perform worse than voluntary processes. Opponents of economic reform normally want the government to play a more intrusive role. This stance is often defended on the grounds that it is more 'democratic', as it enables the state to reflect more effectively the popular will. Critics like Kelsey do not trust markets, that is, the process by which millions of ordinary people exercise their own preferences in a politically uncoordinated way.

The critics' way of thinking reflects a view that governments can be safely given wide discretion because they are sufficiently disciplined by the possibility of electoral defeat. In practice, the outcomes of unlimited democratic politics are likely to be indeterminate and unstable. This is because the so-called 'will of the people' is itself often indeterminate and unstable. For the daily business of taxing and spending, for example, it may provide little guidance.

Take the debate on budget reform in the United States over the last two years. In 1994, a new Republican-dominated Congress tried to implement what it thought was a clear mandate to move towards a balanced budget. The Gingrich team dutifully proposed to reduce the growth of some 'entitlement' programmes to achieve this end. But no sooner had the cuts been passed than President Clinton vetoed them, invoking the support of a new majority opposing them. What then does the majority of US citizens want? A balanced budget or guaranteed entitlement levels? The truth is that they want both – and many also want a tax cut. More precisely, the majority that wants a balanced budget can be trumped by another majority wanting no spending cuts, which may itself be trumped by yet another majority in favour of a tax cut. The 'will of the people' is systematically ambiguous on this central issue of policy.

The mechanism whereby political decisions are made in the United States has been closely studied, largely because it is so blatant. It is known as 'log-rolling': the system whereby representatives exchange support for the constituencies they represent. In principle there is nothing wrong with this sort of wheeling and dealing. Often it is the only way that minority interests can be taken into account: I'll support your motorway proposal if you support my new dam, or whatever. The trouble is that the outcome can easily be a net loss for everyone. A string of legislative measures may all pass under majority rule, but leave everyone worse off than before. Where that happens, the tax bill is likely to be higher than the voters would collectively choose, if they had the chance to do so.

This potentially self-defeating nature of unrestrained majority-rule democracy has been characterised by F A Hayek in these terms:

... an omnipotent democratic government simply cannot confine itself to servicing the agreed views of the majority of the electorate. It will be forced to bring together and keep together a majority by satisfying the demands of a multitude of special interests, each of which will consent to the special benefits granted to other groups only at the price of their own special interests being equally considered. Such a bargaining democracy has nothing to do with the conceptions used to justify the principle of democracy.<sup>6</sup>

The general point here is that widely shared interests do exist, around which we could in principle form a consensus. The issue is how to identify and articulate wider interests and to ensure that they have the weight they deserve in the political process. Often a particular action of a government will not in itself command wide support, but that may not be crucial if the general rule under which that action takes place does command support. As one author has put it:

A community cannot collectively oversee the particular actions of government, whenever and wherever they occur. It can compel government to act according to its collective wishes only by laying down agreed general principles that control the conduct of government.<sup>7</sup>

We are talking here about *constitutional* rules. In New Zealand, we are used to having a simple constitution: a unitary state and a single legislative house with no formal limits on its powers. But the reforms of the last twelve years have given New Zealand what may be loosely termed a new economic constitution. These reforms include legislative changes that are directed not so much towards particular outcomes as towards establishing the rules within which economic policy decisions are taken. The Reserve Bank of New Zealand Act 1989 and the Fiscal Responsibility Act 1994 require the government to comply with open processes with the aim of facilitating policies that reflect long-term and genuinely shared interests, rather than becoming hostage to the short-term interests of influential minorities.

There is some evidence that we have started to detach our judgments about the general interests of society from those of particular interest groups in the way that a stronger constitution could be expected to encourage. Donald Brash, governor of the Reserve Bank, made the following pertinent observation in a recent speech:

Although New Zealanders remain ambivalent about, and even in some respects hostile to, the upheaval of the last twelve years, opinion polls suggest that they agree in increasing numbers, now a majority, that the country is 'on the right track'. Encouragingly, most of them now support the labour market reforms. An interesting contrast can be drawn with the United States, where, although the Congress reliably delivers benefits to the special interests it represents, the population increasingly feels their country is 'on the wrong track'. If people can distinguish between their particular interests and the general interest, there is scope for political leadership to win support for further reform.<sup>8</sup>

People by and large may see only a dim connection between the upheaval of reform and the greatly improved economic performance and prospects of recent years. But, if

<sup>6</sup> Hayek, F A (1979), *The Political Order of a Free People*, Routledge, p. 99.

<sup>7</sup> Ratnapala, Suri (1990), *Welfare State or Constitutional State?*, Centre for Independent Studies, Sydney, p. 20.

<sup>8</sup> Brash, Donald (1996), *New Zealand's Remarkable Reforms*, Fifth Annual Hayek Memorial Lecture, delivered to the Institute of Economic Affairs, London, 4 June 1996, pp. 11-12.

they believe that things have improved, they are unlikely to want to reverse the reforms, which therefore will become increasingly legitimate over time.

### Democracy and Prosperity

An important aspect of the connection between democracy and economic reform is the link between democracy and prosperity. The prime case for democracy is that it is the only system of government consistent with individual freedom. But what if there's a trade-off between individual liberty and economic prosperity? Perhaps the biggest potential test that democracy could face is whether it promotes prosperity better than any other form of government.

There is a school of thought, associated with authoritarians of both the Left and the Right, which denies this possibility. As one writer in the *Guardian Weekly* put it recently: "too much democracy makes for bad economics".<sup>9</sup> On this view authoritarian governments are likely to be more successful economically because they can simply impose economic reform without fear of being rejected by the voters. It is influenced by an interpretation of the economic success of the Asian tigers, which, though scoring highly in terms of economic freedom, score rather low in terms of political freedom. Hong Kong has not even had a government of its own. Roger Douglas reported a trade union economist as saying in 1983, in response to an economic policy package put to Labour's Policy Council: "if you introduce these policies the only way you'll enforce them will be to line people up against the wall and shoot a few of them the way they do in Korea and Taiwan."<sup>10</sup> This view is not just based on Asian examples. Chile is a country that is doing very well economically as a democracy, but it experienced radical economic reform under the military dictatorship that seized power in 1973. The Chilean road to prosperity holds a certain fascination for some elements in the Kremlin. Many believe Russia should have deferred political liberalisation until economic liberalisation had been implemented.

And yet, as a general proposition, the claim that authoritarian government promotes economic prosperity better than democracy is palpably false. Over the last 200 years, it is the democracies of Western Europe, North America and Australasia that have far outstripped most of the non-democratic world in achieving high material living standards. Typically, authoritarian regimes in Africa, Latin America, Eastern Europe and much of Asia have been economic basket cases. Successful authoritarian regimes have been the exception rather than the rule. Moreover, as such countries advanced economically, they have invariably become more democratic.

Separate studies have shown that the underlying motor of economic growth is economic freedom, including the security of property rights, and that democracy is the form of government that is most likely to protect economic as well as political freedom. As a survey 'Democracy and Growth' published in *The Economist* of 27 August 1994 showed, a close correlation exists between democracy, economic freedom and prosperity. Although some authoritarian governments do provide considerable economic freedom, and are trusted by international investors not to change their minds, most do not provide a reliable basis for investor confidence. Authoritarian governments lack mechanisms for peaceful succession; the nature of the new regime is unpredictable; and investors face the prospect of measures which would expropriate or devalue their assets.

In this context it is interesting to speculate whether authoritarian China or democratic India will be the more prosperous in the next few decades. Since the late 1970s China has undertaken radical economic reform, and it will continue on that path while the reforming faction of the Communist party retains the ascendancy. India has more recently initiated economic reform and is persisting with it despite a number of

<sup>9</sup> Thomas, Richard, *Guardian Weekly*, 18 August 1996.

<sup>10</sup> Douglas, Roger, *Toward Prosperity*, David Bateman, Auckland, p. 35.

electoral reversals. As part of its democratic institutions, India also enjoys a developed legal system that facilitates contracts and protects property rights. Because it began its economic reforms earlier, China has made more progress than India, but at some stage it will have to embark on a transition to democracy, with all the perils and uncertainties that lie along that path. The jury on these two countries will be out for some time.

If it came to a choice between, on the one hand, the individual freedoms that are better protected by democracy and, on the other, material progress – more chickens in the pot, as Bob Jones likes to put it – I would be the first to opt for the former. But as a general rule there is no such trade-off – democratic societies are more likely to be economically successful than their alternatives. Of course, it does not follow that democracy guarantees economic success. New Zealand's own pre-reform economic history shows that democracy makes available a particular path to poverty. Observers from Alexis de Tocqueville in the mid-nineteenth century to F A Hayek in the present century have noted the tendency of electorates in democratic countries to throw sand in the wheels of progress, because of the opportunities for special interests to advance at the expense of the general interest and to stifle an economy with taxes and regulation. But, again as our own history suggests, democracies are also capable of self-correction and self-reform. And the best way to ensure that stagnation does not once again creep up on us unnoticed is to strengthen our new economic constitution.

### **Economic Reform and Democratic Consent**

This brings me to my final topic: whether economic reform really can acquire democratic legitimacy. By broadly endorsing the key reforms in the October 1996 election, voters in New Zealand appear to be conforming to an international trend. Everywhere, some people are grumbling bitterly about moves from state paternalism to greater economic freedom, but most are putting up with it, perhaps because there is a general recognition that the alternative does not work. In Britain, Margaret Thatcher remains an unpopular politician, yet 'New Labour' leader Tony Blair openly expresses his admiration for her and promises not to significantly reverse her labour market reforms or her privatisation programme. In Russia, the reforming Boris Yeltsin was re-elected president earlier this year by a wholly unenthusiastic electorate, even though an opportunity to return to communism was there for the taking. In Australia, the ideas that sanction economic reform are routinely and contemptuously referred to as 'economic rationalism', yet there is less chance of reform being reversed there than here, since all the main parties support it.

The most radically reforming government in Australia is Victoria's Kennett government, which, when it came to power in 1992, deliberately imitated Roger Douglas's strategy of rapid and widespread reform. It was easily re-elected in early 1996 and remains way ahead of the Labour opposition, which is now starting to accept that it will never change what has been put in place. At the federal level, the Howard government is still riding high in the opinion polls and at by-elections, in spite of the toughest budget in years and after moves to reform the workplace and to privatise its telecommunications business.

Taken individually, privatisation and the removal of workplace privileges and protection seem unpopular, yet governments implementing such policies gain popular support. I believe this paradox can be explained. Individual voters know when policies and practices don't work. The railway worker who is paid for turning up daily at the workplace and then playing cards can be expected to defend his/her job, but he/she knows that such practices are unsustainable and would not recommend them to his/her children. So the railway worker acquiesces to the necessary changes when they occur.

In Russia, the transition from communism to a market economy is inevitably proving to be a wrenching experience, but a sufficient number of Russians know that a return

to communism would make things even worse, if it could be achieved at all. They know that they have to go through the transition so that their children, at least, have a chance of a better life. So although they will do what they can between elections to avoid the costs of change, at election time their ability to take the long-term view can sometimes come to the fore and induce them to put the general interest before their immediate, particular interests. Indeed, Roger Douglas once made the point that governments actually lose support if they give up on reform. If the National government had spent the last two years pressing on with reform and offering ideas for building on New Zealand's success, I believe it could well be forming its third ministry with a secure parliamentary majority.

Critics of New Zealand's reforms, which are in line with these worldwide trends towards economic liberalisation and civil society rather than state paternalism, have failed to put forward an alternative programme. Repeatedly, Jane Kelsey, Tim Hazledine and others have acknowledged that they have not come up with positive ideas for scrutiny and debate – although of course they tell us they would if they had the time and resources to do so. After 12 years, this argument is wearing a little thin. Policies can only be compared with practical alternatives – not with what might happen in some ideal, imaginary world. Those who only offer criticism and abuse fail to engage in the real issues policy makers are forced to confront, and we are entitled to regard their contributions as empty.

The greatest risk for New Zealand now is a continuation of government inaction. It has been said that, if coalition governments under the Mixed Member Proportional electoral system (MMP) are so constrained by intra-coalition compromises that they are unable to extend the reforms, they will at least be unable to reverse those that have already occurred. This may be partially true – in regard, for example, to changes which would require specific legislation. But many expenditure increases or additional regulatory controls that do not require parliamentary sanction could easily have disastrous economic and social consequences. Moreover, if Roger Douglas is correct in saying that loss of reform momentum leads to loss of political support, governments beset by policy paralysis are likely to create opportunities for populist anti-reform parties or party coalitions to gain the initiative. The politicians now have to find a way of building on the last dozen years of change in the context of MMP. Those of us who are enthusiastic about those changes must therefore continue to defend them strenuously.



**WORLD BANK CONFERENCE  
MAJESTIC CENTRE WELLINGTON**

**FROM BASKET CASE TO CASE STUDY  
NEW ZEALAND 1984-96**

**SIR RONALD TROTTER  
MEMBER  
NEW ZEALAND BUSINESS ROUNDTABLE**

**WELLINGTON  
9 DECEMBER 1996**

## FROM BASKET CASE TO CASE STUDY: NEW ZEALAND 1984-96

It is a great pleasure to be opening a conference which will feature contributions by so many of the people who have helped transform the New Zealand economy and give our country a future. Since 1984 New Zealand has seen a remarkable period of economic change. It has been a transformation which has not gone unnoticed in the rest of the world. But while the reforms have won much international acclaim, some people in New Zealand have short memories. They have forgotten that for 25 years or more prior to 1984, New Zealand's economic performance was a disaster.

New Zealand once had the third or fourth highest average living standard of any country in the world. By 1984 we were 23rd in the Organisation for Economic Cooperation and Development (OECD), and continuing to lose ground relative to both the developed and the newly industrialised economies. Our productivity growth had for decades been the worst of any OECD country, as had our per capita economic growth. Unprocessed pastoral products still accounted for the bulk of our exports, and our manufacturing sector was grossly inefficient. Since the first oil shock economic growth had slumped, and unemployment had begun trending upwards. At the same time we were failing to live within our means as a country and were seeing a rapid build-up in both foreign and domestic debt.

This outcome was due to economic policies that were arguably the most interventionist outside of the third world and the Iron Curtain countries. We were a highly protectionist economy: high tariffs and import licensing were articles of faith. Domestic competition was severely restricted, if it was allowed at all. Almost every significant sector was extensively regulated. Thanks to the political clout of our dairy industry, you needed a doctor's prescription to buy margarine. When shops were finally allowed to open on Saturday morning – after bitter opposition – this was considered a major liberalising move. Tourists joked that they came to New Zealand and found it shut. To cap it off, we had one of the most inefficient and inflexible industrial relations systems in the developed world – craft-based trade unions and a national award system that applied to all workplaces regardless of their individual circumstances.

Almost every economic policy was shaped by the specific interests of a pressure group. Indeed, our economy was one huge interlocking grid of special interests, walking around with their hands in each other's pockets. Manufacturers were vigilant at clinging on to their protected status. The resulting cost structure meant that exporters were often struggling. However, rather than reform the domestic economy, the government's response was to subsidise exporters. The unions guarded their own privileges jealously and often used their monopoly power to obstruct more productive work arrangements. Management tended to acquiesce in this industrial vandalism; it was much simpler to fly to Wellington and lobby the government for special favours than to make their own workplaces more productive.

Naturally we all learnt to play the lobbying game – even those who realised the rules were absurd. I well remember when Morrison Industries – a company with which I was associated – obtained the right to manufacture bicycles. We put our case before the Tariff and Development Board – the words 'tariff' and 'development' went together in those days – and won. Bicycle imports were reduced to a token level. The officials became quite enthused about this great new manufacturing 'winner' they were picking. It was not hard to pick the loser in this deal – the consumer. The consumer lost out every time.

New Zealand's state sector fitted this environment of special interest politics like a glove. Most government services were monopolies. Almost all were inefficient and overstaffed; they had no incentive not to be. The poor quality of their services constituted a burden on the private sector. For instance, a new business starting up had an average wait of six weeks just to have a telephone installed. But there was no question under our old economic regime of making government trading organisations more efficient. We had to protect the 'jobs' of people 'working' in these departments. They constituted a powerful special interest of their own.

The late Sir Robert Muldoon – whose tenure as prime minister can tactfully be described as idiosyncratic – raised the policies of government intervention almost to an art form. Finding something in the economy still moving in 1982, he slapped a comprehensive freeze on all wages, prices and interest rates. His tenure was abruptly cut short by a snap election which he lost.

Such was the state of the economy inherited by the man who will be speaking next – Sir Roger Douglas. The day after winning the general election in 1984, the Labour government was informed that it faced a foreign exchange crisis. Within days the situation had escalated into a constitutional crisis. Decisive corrective action was required and was boldly taken. The currency was devalued and interest rate controls were removed in order to allow monetary policy to defend the new exchange rate. Price controls were quickly removed.

Two enormous tasks followed. The spiral of fiscal deficits, public debt and credit downgrades had to be reversed, and markets had to be freed up to allow the private sector to generate sustainable economic growth. These twin tasks of stabilisation and liberalisation took most of the next decade. The programme constitutes what a former OECD senior official, David Henderson, has called "one of the most notable episodes of liberalisation that history has to offer".

Before summarising for you some of the principles driving the reforms, I want to take this occasion to comment on how this remarkable episode occurred.

In my view it resulted from an extraordinary constellation of events, ideas, courage, vision, leadership and ability to execute. The critical trigger was the external debt crisis. As Mancur Olson has noted, successful domestic reforms often appear to follow from severe external threats and shocks. New Zealand's experience appears to fit this mould.

There is more to it, however. For example, New Zealand's 1938 foreign exchange crisis moved policy in an inward-looking, defensive direction. This was exemplified by the adoption of import licensing as a 'temporary measure'. Why did New Zealand move in the opposite direction in 1984?

The need for fundamental change had long been obvious to many politicians, including many in Muldoon's cabinet, many business leaders, the government's key policy advisers and many practising economists. Roger Douglas published a book in 1980. Its title adequately captures its spirit. It was *There's Got to Be a Better Way*.

These politicians provided the leadership, vision and courage for what was to follow. Key figures in the 1984–87 period were the prime minister, David Lange, the minister of finance, Roger Douglas, and those assisting with the finance portfolio, Richard Prebble and David Caygill.

Treasury, which had been unsuccessful in the battle against Muldoon's disastrous 'Think Big' government investment projects and the two-year wage and price freeze, had clear views on what needed to be done. Those views were pulled together as a post-election briefing for the incoming government in the few weeks following the announcement of the snap election in mid-June 1984.

Published some months later under the title of *Economic Management*, this briefing provided the intellectual basis, the strategy and the blueprint for the subsequent reform programme. Graham Scott in the Treasury oversaw the preparation of this briefing and Roger Kerr was his right hand man.

The story was much the same at the Reserve Bank, except that its views were better known through its research publications and the prominence of Roderick Deane. The three public servants I have just mentioned made outstanding contributions to what was to follow.

Meanwhile, and entirely independently, some leaders in the business community had decided that they had had enough of the old ways. I am proud to be associated with those who set up the New Zealand Business Roundtable, an organisation of chief executives of New Zealand's larger companies. It is unusual among business groups in that it has been dedicated from the outset to the proposition that the interests of the business community are likely to be best served by policies which are in the long-term interests of consumers and the economy overall. This means open and competitive markets and smaller rather than larger government.

The organisation's role is to commission, publish and disseminate the best possible research and analytical contributions to public debate. It is not a lobby group but relies instead on the power of ideas. Roger Kerr was appointed as our executive director in 1986. He has conceived and executed a large work programme including many contributions by international scholars. His influence has been immense. The importance of basing reforms on a strong and consistent intellectual framework, articulated in a way that can be widely understood, cannot be over-emphasised.

However, it would be wrong to give the impression that other organisations were not also moving with the times. Under the leadership of Ian Douglas, manufacturers were moving to support free trade with Australia. That was the start of an enormous shift in thinking for the Manufacturers' Federation. Today this formerly most protectionist of the business organisations stands with the Business Roundtable and Federated Farmers in supporting the elimination of all tariffs.

One of the most notable stories is that of Federated Farmers. This organisation had to cope with the prospect of widespread bankruptcies among farmers early in the reform programme. The problems arose because the elimination of farm subsidies coincided with high real interest rates and a sharp increase in the real exchange rate. The last of these arose from increases in government charges and the large and unfortunate surge in wage rates which followed the ending of the wage and price freeze.

Under Peter Elworthy's leadership, Federated Farmers resisted pressures from its members to call for a reversal of these policies and a return to subsidies, lower interest rates and an artificially lower dollar. Instead it called for an extension of the reform programme.

It is a reflection of those times that the Labour government responded in a manner which would previously have been unthinkable. In December 1985 it issued a statement of policies to support farmers – by lowering tariffs and phasing out import licensing.

Interestingly, one group which had little to do with the reform programme and in general remained wedded to outdated economic thinking was the academic community. As David Henderson has noted:

... academic economists in New Zealand appear to have been not only more divided about reforms ... but actually on balance hostile, possibly to a greater degree than in any other OECD country.

It is difficult to communicate today the enthusiasm generated in the mid-1980s between the public and private sectors by the government's evident commitment to policies likely to serve New Zealand's best long-term interests.

Richard Prebble reported in his recent book, *I've Been Thinking*, that when he was minister of state-owned enterprises he approached 200 top business people to serve on their boards. Their potential legal liabilities would be enormous, and the annual remuneration he could offer represented about one day's pay in terms of their opportunity cost. Yet only three of these 200 turned him down.

Following the 1987 election and the collapse of the Lange-Douglas administration, we must give credit to David Caygill and Ruth Richardson as key supporters of the path-breaking Reserve Bank of New Zealand Act 1989 and continued tariff reductions. After the change of government in 1990, other vital reforms were the Employment Contracts Act 1991, introduced by Bill Birch, and the Fiscal Responsibility Act 1994, which was the work of Ruth Richardson.

The reform programme has been sustained during the terms of four prime ministers and four ministers of finance. It now faces the test of the first Mixed Member Proportional (MMP) parliament. This parliament has no mandate to alter the basic policy framework.

How is it that a reform programme can be so robust?

The two dominant figures in those respective governments, Roger Douglas and Ruth Richardson, will shortly be giving you their own analyses of the situation. I will content myself with stressing some of the broad principles which drove the reforms. It was the consistency with which these principles were implemented – across a wide range of areas – which distinguished the New Zealand liberalisation programme.

First, our reforms were from the start focused on the medium term. *Ad hoc* responses to short-term problems – which had bedevilled economic policy making in New Zealand – were largely rejected. The attitude adopted was that if a policy was not good for the medium term it was not good – period. The new focus was especially apparent in macroeconomic policy. In the past, monetary policy had often been subordinated to the short-run goals of boosting economic activity and jobs – usually in an election year. The result was predictable: high inflation, big fluctuations in output, but hardly any growth. After 1984, monetary policy settled into its proper medium-term role of ensuring price stability. Fiscal policy had likewise been aimed at propping up economic activity in the very short run, with serious consequences for debt and interest rates. Under the reforms, fiscal policy took on an increasingly medium-term orientation, aimed at controlling, reducing and eliminating the fiscal deficit.

A second principle of the New Zealand reforms was that special interests should no longer be allowed to dominate over the wider interests of the community. Every New Zealander is, ultimately, a consumer, and will benefit in a policy setting where resources are used in the most efficient manner. In the end, enough sector groups realised that everyone would benefit if we had an economy in which no one's special interest held the legitimate interests of others to ransom.

A third principle that drove the reforms was the recognition of the central role of competitive markets in creating wealth. The incentives in markets far surpass those that operate within a centrally planned system. And the ability of markets to harness and coordinate widely dispersed information, through the mechanism of the price system, vastly exceeds the capacity of central planners. Mainstream economics has long known these truths, and they have been repeatedly demonstrated in recent history by the success of market economies. But in New Zealand prior to the reforms,

even many business people had an instinctive distrust of market forces and believed that markets needed to be heavily regulated.

A fourth principle behind our reforms was the conviction that New Zealand needed to open itself up to international competition and to international influences generally. The insular assumption that New Zealand industries could not compete, and had to be protected, was progressively abandoned. We discovered we could compete on world markets if the government addressed the inefficiencies elsewhere in the economy which had raised costs and compromised productivity. The last few years have seen a rapid growth of high value-added manufactured exports, and defeatist attitudes are now a thing of the past. New Zealand has become more integrated with the rest of the world in many other ways. Foreign investment has flowed into the country, and immigration is bringing people with important skills and links to overseas markets.

A fifth principle of the reforms was that there is no economic logic in viewing the labour market fundamentally differently from the way we view any other market. There is nothing in this crucial market which stops the laws of supply and demand from operating. On the contrary, labour markets work best for both workers and employers where employment contracts can be freely negotiated and where policy makers resist the temptation to 'help the worker' by imposing statutory monopolies or privileges on unions. That is the lesson from countries with relatively flexible labour markets such as the United States, Switzerland, Japan and the Asian tigers. With the passing of the Employment Contracts Act 1991, New Zealand joined this group.

A sixth principle of the New Zealand reforms was a recognition that, while market failure sometimes occurs, government failure is also a very real feature of the world and cannot be ignored when designing policy. Government failure can occur when the political process is captured by interest groups, or when governments substitute short-term political goals for sound medium-term policies. Implicit in virtually all of the New Zealand reforms was a realistic appreciation of the potential for this type of failure. In our new monetary and fiscal policy framework the recognition of the potential for government failure probably went furthest. Thus we have the Reserve Bank of New Zealand Act 1989 which entrenches in law the explicit goal of price stability. We also have a Fiscal Responsibility Act 1994 that sets down criteria for fiscal disclosure and principles of responsible fiscal management – such as running a balanced budget and achieving a prudent level of debt – which a government must follow over the medium term.

A final principle of the reforms was a recognition that, if a government wants to redistribute income, it should take the direct and obvious route of using the tax and social welfare system for that purpose. Prior to our reforms, many features of our economy involved implicit redistribution between one group and another. Partly through confused notions of what was 'equitable', our whole economy had become a network of cross-subsidies. For instance, many goods and services produced in the state sector were underpriced, with obvious consequences for resource misallocation. The reformers realised that in the end such an economy made everyone poorer.

These, then, were some of the key principles behind our reforms. Their benefits are now undeniable. After a difficult five years following the 1987 sharemarket crash, the New Zealand economy has performed well since real gross domestic product bottomed in June 1991. Growth has averaged around 4 percent per annum. More importantly, New Zealand has demonstrated the capacity to grow in a sustainable fashion. Inflation has been controlled within or near its 0–2 percent target range. In place of running large fiscal deficits, we are now producing sustained fiscal surpluses – a development which has enabled the government to repay all of its net foreign currency debt while simultaneously cutting personal income tax. New Zealand's international credit rating has overtaken Australia's. Unemployment has fallen from its peak of 10.9 percent to 6.3 percent today – one of the lowest rates in the OECD.

It would be wrong, of course, to imply that all worthwhile reforms have been implemented, and that policymakers can now put their feet up and enjoy the gains. Life is not like that. The world does not stand still. While New Zealand pauses to negotiate a coalition government – with the prospects of more spending here and greater compulsion there – many other countries are moving ahead. New Zealand is still a highly taxed country relative to its Asian trading partners, and others are moving more quickly to restrict the scope of government activity so as to allow more scope for private enterprise.

We continue to wallow in mediocrity in our systems for the delivery of health and education. Community dissatisfaction now focuses on these sectors which, almost alone in the economy, are characterised by dominant state providers and a lack of competition.

An even bigger issue for western nations like New Zealand is the future scope of the welfare state. Far too many able-bodied people live on welfare, and the talk is of adding to this by raising, rather than abolishing, the minimum wage. The welfare system subsidises those who have more children than they can afford to bring up and rewards men who abandon their responsibilities. The breakdown of the family unit is one of the most distressing statistics of our times.

Our system of accident compensation is a debt-ridden and divisive national disgrace. And because a few throw themselves on the mercies of others when it comes to retirement savings, it is seriously being contemplated that the savings of all of us must be regulated because big brother knows best. A compulsory savings scheme, if implemented, would be another enormously costly regulatory monster.

In recent years, as in many industrialised countries, there has been an orgy of over-ambitious regulations of a social engineering nature. The Employment Court, the Bill of Rights Act 1994, the Human Rights Act 1993, the Fair Trading Act 1986, the Securities Amendment Act 1996 on insider trading, the Health and Safety in Employment Act 1992, the Privacy Act 1993, the Treaty of Waitangi legislation, the Resource Management Act 1991, the BioSecurity Act 1993, the Commerce Act 1986, various tax rulings and countless other pieces of legislation are frustrating and bewildering commerce in innumerable ways. Meanwhile government expenditure has resumed its menacing upward creep. Add to these problems wage pressures in the non-traded goods sector and the danger signals for New Zealand's external competitiveness are obvious.

While New Zealanders can take real pride in the quality of the past reforms, we cannot eat last year's bread. The baker must return anew to the ovens each day, and so must any country that wants to raise its living standards. We have with us in this conference some who have excelled as reformers in the recent past. We can learn from their wisdom, but the task of moving ahead is a fresh responsibility and a shared one. New Zealand is still operating well below its potential and can do far better yet, given political leadership and informed public opinion. The same goes for most other countries.

I look forward to learning your ideas on how all of our countries can deal with the challenges and opportunities open to us as we approach the twenty-first century.

**FISCAL POLICY AND THE PUBLIC  
SECTOR**



**ROTARY CLUB OF RICHMOND**

**THE 1997 BUDGET**

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

**RICHMOND  
12 MAY 1997**

## THE 1997 BUDGET

In just over a month's time, the coalition government is expected to deliver its first budget. This will be an unusually important document. The outlook for the economy will be strongly influenced by whether the government takes decisions which arrest the loss of economic direction, the policy slippage and the downward trends in business confidence that have set in since the October 1996 election.

Recent developments bring to mind the words of the Paul Simon song: "the nearer your destination, the more you're slip-sliding away." The first half of the 1990s saw the remarkable turnaround in the New Zealand economy as a consistent economic policy framework, and a clear sense of economic direction was achieved in the reform programme. Growth, investment, employment and the government's budget position all improved dramatically. More recently we have failed to push ahead and the slide has been accentuated since the election. Not surprisingly, the number of people who think New Zealand is on the right track has fallen every month since the election and now more people think the government is on the wrong track than the right one.

It is important to get these developments into a proper perspective. It was perhaps not surprising that the economy slowed somewhat after the high growth rates of 1993-95. Opponents of the reforms could hardly wait to pronounce that all we had seen was a short-lived growth spurt rather than any sustainable gains. This is a ridiculous view: we are still experiencing the longest expansion of economic growth since at least 1965, inflationary pressures have been kept well in check, and more than 240,000 jobs have been created since 1991. If all these people resided in the same area they would constitute the largest city in New Zealand after Auckland, Christchurch and Manukau.

Nevertheless, recent progress has been unexciting. Believe it or not, we have been in an economic trough now for about two years, with annual growth running at about a 2.5 percent pace. Still, that growth at the bottom of a cycle is better than the *average* growth in the 10 years to 1980 of around 1.5 percent, and it has been associated with a continuing decline in public debt levels, not a build-up of debt.

The main point to make, however, is that a 2.5 percent growth rate falls far short of the economy's potential and the coalition's growth objectives. The National party has a target of 3.5-5 percent annual growth to the year 2010, and New Zealand First aims to raise the growth rate to 6 percent by 1999. Neither target is remotely plausible on present policies. The key thing to look for in the budget will be the coalition's indications of how it proposes to achieve its stated growth objectives.

What are the reasons for the much more subdued growth outlook and the fall in business confidence? The first and most important is the progressive loss of fiscal discipline in the last parliamentary term and since the election, particularly the massive rise in government spending.

Over-spending by New Zealand governments was a chronic problem throughout the 1970s and 1980s, and a major factor in the poor economic performance of those decades. Central government's share of the economy rose from its level of 25-30 percent in the 1960s to a peak of over 41 percent in 1990/91. This relentless upward trend squeezed private sector growth, put pressure on monetary policy and internationally competing industries, and resulted in higher taxes and borrowing, inflation, rising debt levels and falling credit ratings.

Despite Roger Douglas's efforts, the Labour government never succeeded in reimposing strong fiscal discipline in key areas. That only happened with the 1991 budget, which reduced the pressure on financial markets and the exchange rate and

laid the basis for the export- and investment-led recovery which followed. Now we are at risk of losing many of those gains.

Consider the following figures. The previous government's success in turning a large operating deficit in 1990/91 into a substantial surplus four years later reflected two factors. First, it was able, largely through economic growth, to raise \$5.2 billion more in revenue in 1994/95 than in 1990/91. Secondly, the government was able to hold the increase in non-finance expenses (that is, spending other than on debt servicing) to \$1.1 billion in nominal dollars (that is, before inflation), while financing costs fell by \$1.5 billion due to lower debt.

In sharp contrast, in the five years to 1999/00, government spending other than on debt servicing is projected to rise by nearly 16 percent or \$4.2 billion in real terms – nearly four times as much as in the previous four-year period. We have already seen some of the consequences of these decisions. High interest and exchange rates have been squeezing the export sector, the 1997 tax cuts which would have brought relief to many low income earners have been deferred, and in the next three years taxes will be \$5 billion higher in total – or nearly \$25 a week for every household over that period – than they otherwise would have been. In addition, the widening of the Reserve Bank's target range appears to have added half a percentage point to long-term interest rates and therefore to the costs of borrowing of firms and households.

Moreover, much of the new spending is misdirected and of low quality. With the exception of a few of its members who still seem to be attracted to government hand-outs, the business community has rejected the proposed \$100 million of business assistance. However, it seems that the government has merely turned around and decided to spend the same amount on a new building for politicians. Much of the proposed spending in the budget will benefit well-off people, not those in genuine need. For example, around 93 percent of the proposed increases in tertiary student allowances will go to people from families earning over \$50,000 a year. The removal of the superannuation surcharge and the decision to make doctor visits free for children under five are also regressive in their effect. Overall, this is the most poorly conceived fiscal package we have seen for many years.

There has been almost universal criticism from economic and business commentators of the loss of fiscal discipline and the growing imbalance between monetary and fiscal policy which has contributed to the economic slowdown. The government's attempts to defend it have seemed half-hearted, and the points it has made have been unpersuasive.

First, the government has pointed out that it continues to plan for substantial surpluses and to repay debt. It is true that excessive government borrowing is no longer adding to the risk premium in New Zealand interest rates and absorbing private savings, but unsustainable deficits are only one aspect of bad fiscal management. Increases in government spending have independent effects, particularly by adding to demand pressures and hence cost increases in the non-traded goods sector of the economy. It is these cost increases which are causing the real exchange rate to rise and squeeze the export sector, and it is wrong to blame monetary policy for this outcome.

Secondly, the minister of finance has pointed out that the ratio of government spending to gross domestic product is still projected to decline, despite the extra \$5 billion in spending, from 34.7 percent of gross domestic product (GDP) this year to 32.1 percent in 1999/00, partly due to the continuing fall in debt servicing expenses. But what Mr Birch has not acknowledged is that his projections of only two years ago had government spending falling to 30.5 percent of GDP this year. The government's target of reducing expenses to below 30 percent of GDP has been rapidly slip-sliding away. I would not be surprised if the budget reveals a weaker growth outlook than the March 1997 Budget Policy Statement, in which case the target may recede further.

Thirdly, the government has been rather lamely arguing that if Labour and New Zealand First had ended up as coalition partners, the fiscal outlook would have been even worse. This may be a fair point: Labour still describes itself as a spending party whereas Tony Blair's Labour party has pledged to be at least as tough on public spending as its predecessor and to cut income tax rates further. If the political alternative would have been worse, this simply underlines how far all our major parties have abandoned policies of sound fiscal management.

When one looks around the world today, there can be little doubt that the countries that are doing most to create jobs and raise incomes are, generally speaking, those that have kept their public sectors small and their tax rates low. By contrast, high-spending, high-taxing countries, such as those in Europe, are stagnating with high levels of unemployment and increasing social stress.

A recent International Monetary Fund (IMF) working paper looked more closely at the growth of government spending and its effects over the last century. Prior to World War I, government spending in industrialised countries averaged less than 10 percent of GDP; in the United States it was under 2 percent. The ratio rose with the two World Wars and the Great Depression, but was still only just over 25 percent by 1960. However, the biggest rise in government spending came with the subsequent expansion of the welfare state, which took the average ratio to 45 percent by 1990. The growth in the size of government in the New Zealand economy followed a broadly similar pattern.

The IMF researchers examined a range of economic and social indicators and found that recent government growth has not brought about much economic or social progress. Countries with the lowest increase in public spending tended to be more efficient and innovative, and enjoyed lower unemployment. Nor did the wealthy industrialised countries have significantly better performance on measures of education and health than newly industrialised countries where spending averages only 18 percent of GDP. The authors concluded that "most of the important social and economic gains can be achieved with a drastically lower level of public spending than what prevails today" and predicted the next few decades would see important reductions in the share of public spending in advanced economies.

It is also worth noting that there are few signs of growth in the relative size of the public sector in the low tax countries. Hong Kong, for example, has followed a rule of not allowing government expenditure growth to exceed the growth rate of the economy. This seems unlikely to change: in the lead-up to the recent Hong Kong budget, China, the world's last great communist power, was urging Hong Kong to contain its welfare spending. This has increased in recent years, and there are signs of a dependency problem developing. Hong Kong's top marginal tax rate is 15 percent, and there is pressure to cut the 16.5 percent corporate tax rate on the grounds that Hong Kong's economy is becoming uncompetitive.

The IMF research focused mainly on the poor returns from many government spending programmes. A separate factor which impacts on economic performance is the taxes required to finance them. At current levels, the economic or 'deadweight' costs of taxation are high. The costs in question are not just the administrative and compliance costs involved with any tax system; the more important economic costs result from the disincentives to work, save, invest and take risks. Because of these effects, transferring a dollar of income from Peter to Paul costs more than a dollar of national income – the process is like transferring water in a leaky bucket. Studies for New Zealand suggest that an additional dollar of spending could cost the community anywhere between 14 cents and 270 cents of lost income. If a deadweight loss of 20 cents per dollar applied to the coalition's \$5 billion spending package, we would lose \$1 billion of potential national income or over \$800 each year for every household.

A recent study by Professor Gerald Scully for the Department of Inland Revenue concluded that the growth-maximising spending ratio for New Zealand is about 20 percent. It is hard to see how government spending on genuine public goods and a well designed social safety net would amount to 20 percent of GDP in a well functioning, high income economy. Nevertheless, in a report entitled *Moving into the Fast Lane* (1996), the New Zealand Business Roundtable, in association with the Auckland and Wellington chambers of commerce, advocated as a conservative target a medium-term ratio for total government spending of 20 percent or below by 2005. Combined with other measures, we firmly believe such a reduction of the government spending and taxing burden would lift New Zealand's growth performance to the levels targeted by the coalition parties.

Achieving such a ratio does not necessarily require large cuts in government programmes; the falling ratio of recent years has occurred largely because government spending growth has been held below growth in the economy. But there is clearly enormous scope for reducing government spending that is not cost effective or well targeted. In many instances activities and functions should be eliminated or privatised. A large number of possibilities were put forward in *Moving into the Fast Lane*. In tandem with lower taxes, there is clearly room for significant privatisation of pensions, education and health care, since a large proportion of the outlays go to people who paid the taxes to provide them in the first place. Such 'churning' of income only adds to deadweight losses while inhibiting choice, flexibility and accountability. The government's focus should be on assisting those who would not otherwise be able to access basic social services. And I can assure you from first-hand experience that there is still a great deal of wasteful bureaucracy and regulatory administration in both central and local government.

There are other factors within the government's control which are contributing to the rather mediocre economic outlook. They include the growth in meddlesome – and often utopian – regulation of the private sector, the reluctance to expose state activities like the Accident Rehabilitation and Compensation Insurance Corporation and the producer boards to greater competition, the standstill on privatisation of government-owned businesses, and the proposal to introduce a compulsory saving scheme. All these are, or would be, a handicap to growth. The decisions against privatisation seem to have been made on ideological grounds – ministers make no attempt to defend them on national interest grounds. The proposal to regulate private savings is being put forward at a time when the government is spending more and reducing its own savings: a 'do what I say, not what I do' approach. The proposed deregulation of postal services is a welcome move and seems to have been accepted with little fuss, but it is a move we have been advocating since an initial inquiry in 1988. As well as moves to restore firm spending discipline, the business community will be looking for indications in the budget that the government will be making up for lost time on microeconomic reform.

In an optimistic review of the world outlook earlier this year, the former deputy editor of *The Economist*, Norman Macrae, wrote:

Twilight will start to fall on the era of big government across the world in 1997. ... Good governments will spend less of their people's money ... and so start providing a much better welfare state.

These lessons from experience are still not accepted in many quarters in New Zealand, including our main political parties. Spending lobbies like to quote Oliver Wendell Holmes: "Taxes are what we pay for civilised society". When Justice Holmes made that remark the average American's tax burden was about 7.6 percent of personal income. Today people on close to the average wage in New Zealand pay an income tax of 33 percent and a further 12.5 percent in GST on their spending. Many people effectively work two days in every working week for the government. How many people think today that the higher our taxes the more civilised we are likely to be?

Similarly, how many think that spending another billion dollars on our dysfunctional health and education systems will make any more difference than spending a billion dollars on the Post Office or the government electricity department would have made to our telecommunications or electricity services in pre-reform days? Education and health services (with the exception of primary health care, which is mainly provided by private general practitioner businesses and is largely free of complaints) will remain prime sources of public dissatisfaction so long as they are state-provided, sheltered from competition, and dominated by unions. We don't hear similar complaints about private sector services such as those provided by supermarkets, service stations, accounting firms or insurance companies, but the penny doesn't seem to drop. Without basic reforms, no amount of extra spending will make much difference to education and health. And yet spending heavily on government-provided social services is precisely what the government seems likely to do in next month's budget.

It is difficult to see that Macrae's optimistic outlook extends to New Zealand. World growth this year is expected to be of the order of 4.4 percent, but New Zealand will clearly not match that figure. The expected pick-up in activity looks to be weaker and slower in coming. Last week's unemployment figures suggest the fall in unemployment has come to an end for the time being. A disappointing budget would depress business confidence and activity further.

Regrettably, the government seems no longer to be listening to those who have been arguing that its policies are going in the wrong direction. In March the National Bank asked the question: "Can we say that the March 1997 Budget Policy Statement is fiscally prudent?" and replied: "The answer is emphatically No!". The response by the minister of finance was: "I think they grossly overstate their case. That's not helpful to anyone."

Similarly, the Business Roundtable recently warned the government that the prospects of New Zealand regaining a Triple A credit rating were receding. Mr Birch rejected that assessment and accused us of "needlessly and irresponsibly fuelling overseas concern". But what the business community would like to hear from the government is how its decisions to spend an extra \$5 billion and relax the Reserve Bank's target band, and its lack of vigorous action in pressing on with necessary microeconomic reforms, are advancing the prospects of a Triple A rating. It is a matter of simple logic that these factors will make financial markets and rating agencies more cautious about New Zealand. The government has not demonstrated its confidence by setting a target date for achieving a Triple A rating. Contrary to Mr Birch's optimism, last week Standard and Poor's scotched the idea that there is likely to be any upgrade in New Zealand's credit rating in the immediate future.

In some ways the present economic and political environment is reminiscent of the period 1988-90. After four years of bold and overdue reforms, the government of the day called for a cup of tea. Business confidence slumped. The Business Roundtable and others repeatedly warned about the damaging effects of the loss of fiscal discipline and economic direction, but to no avail. New Zealand suffered a prolonged recession and a downgrading of the credit rating in 1991, and a further downgrade was only narrowly averted by the budgetary and other measures of that year.

Are we condemned to repeat history? One thing that has changed from the Muldoon years and the associated 'economy of fear' is that critics of government policies are unlikely to be silenced simply by reactions that they are 'unhelpful' or 'irresponsible': more people are prepared to stand up and be counted. Another is that the country has become more economically literate, as the polls indicate many people lack confidence that the government is on the right track. Sooner or later politicians are likely to notice such signals.

As for the budget, the business community must hope for the best and prepare for the worst. If there are no new initiatives to control government spending and promote growth, my assessment is that business will remain quite defensive in its investment plans and that the weak phase of the last two years will be extended. If, on the other hand, the government has been listening to those who are keen to see it build on New Zealand's achievements in the last 12 years and reach its growth objectives, we should expect a new phase of reform which would move the economy forward again. In about a month's time we will know which scenario is more likely.

**INSTITUTE OF CHARTERED ACCOUNTANTS  
AUCKLAND LUNCHEON CLUB**

**PRIVATISATION  
A FORGOTTEN POLICY?**

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

**AUCKLAND  
18 APRIL 1997**



## PRIVATISATION: A FORGOTTEN POLICY?

An Argument Won

*"Privatisation has undoubtedly improved efficiency and led to greater consumer focus"*

Fabian Society<sup>1</sup>

All over the world today, governments are engaged in privatisation. In the ten years to 1995, total sales of state-owned enterprises (SOEs) amounted to US\$535 billion.<sup>2</sup> That's an unprecedented shift of resources from the public to the private sector.

And the pace is still accelerating. In the March 1997 issue of *Financial Market Trends*, the Organisation for Economic Cooperation and Development (OECD) estimates that privatisations in its member countries, already at an all-time high last year, could reach a record US\$100 billion in 1997. It expects this total to be boosted by a rebound in privatisations in non-OECD countries, notably Brazil.

Latecomers to privatisation have joined in. In 1996 privatisations in OECD countries rose by nearly 30 percent, with most occurring in Europe. Holland has privatised its postal service and Sweden has moved two of its public universities into private non-profit trusts. Last year privatisations in Australia amounted to US\$9.6 billion, according to the OECD, and are expected to amount to a further US\$7.1 billion this year. In just two years asset sales in Australia will have exceeded in value New Zealand's entire privatisation programme since 1987.

In addition, there is huge private investment around the world in infrastructure projects – roads, water and sewerage, electricity, ports, airports and so forth. One Australian banking firm recently put the total value of prospective federal and state projects in that country involving private sector participation at A\$75 billion.<sup>3</sup>

Although privatisation is often considered an ideological issue, it has in fact become non-partisan and non-ideological. It has been embraced by governments of all political persuasions, including socialist governments in Spain and Sweden, populist governments in Argentina and Mexico, former communist governments in Russia and Eastern Europe, and even by the few remaining communist governments such as China, Cuba and Vietnam. Robert Poole of the Reason Foundation, Los Angeles, noted in a paper given in New Zealand last year that at both federal and state level in the United States privatisation has become a non-partisan issue.

The contrast between the current state of affairs in New Zealand and these developments around the world could hardly be more striking. At central government level the coalition has no firm plans to privatise anything. At the local government level there are few significant initiatives in the pipeline. The Auckland Regional Services Trust (ARST), which was set up with the explicit task of divesting most of its assets, is showing every sign of wanting to sit on them and perpetuate its existence.

With the exception of ACT New Zealand, none of our significant political parties is strongly committed to privatisation. I don't recall a single speech by Philip Burdon as

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<sup>1</sup> Quoted in Department of Trade and Industry, *Privatisation: Setting Enterprise Free*, London, February 1997.

<sup>2</sup> John O'Leary (ed), *Privatization 1995*, Reason Foundation, Los Angeles, 1995.

<sup>3</sup> 'Jobs Swap in Privatisation Race', *Australian Financial Review*, 26 March 1997.

minister of state-owned enterprises or Bill Birch as minister of finance in the last government cogently arguing the case for it. This year ministers have been falling over themselves to tell us what they're *not* going to privatise – from the government's electricity businesses and Television New Zealand to the Accident Rehabilitation and Compensation Insurance Corporation (ACC). In a few years' time New Zealand will probably be the only respectable country with a largely government-run electricity system. We look like becoming the dunce of the class again. Warren Kyd, who has been arguing for ACC to be privatised, and David Hawkins, who has been advocating and implementing privatisation in his role of mayor of Papakura, stand out like isolated beacons of light on the issue.

Why has New Zealand so comprehensively dropped the ball on privatisation while the scores are mounting around the world? Clearly the answer is not that there is nothing left to privatise. As the Treasury noted in its briefing to the incoming government, SOEs are a major component of both the central government's balance sheet and the wider economy. Their total revenue equates to over 5 percent of gross domestic product (GDP). As at June 1996, their assets of \$12.5 billion comprised 21 percent of the book value of total government assets and were equivalent to about 28 percent of the asset book value of the New Zealand Stock Exchange's top 40 group of companies. I would be surprised if the ratio of the capitalisation of government-owned companies to privately listed companies came to anything like that figure in most, if not all, other OECD countries, and in most Asian countries as well.

At the local government level, to give just two examples of the scale of publicly owned businesses, the net assets of the ARST amount to around \$540 million or over \$1,500 for every household in the Auckland region, and the investment by local government in water supply and wastewater assets is of the order of \$6 billion, larger than the total investment in Telecom's network. Clearly a significant fraction of the New Zealand economy, which could be run by firms and business people in the same way as other businesses, continues to be run by governments and politicians.

Similarly, the resistance to privatisation in New Zealand cannot be explained by the argument that the evidence in favour of privatisation is not clear-cut. Fifteen years ago it might have been possible to make that argument with some degree of plausibility. Only Britain at that time had embarked upon privatisation as a major policy. The argument largely had to be carried on theoretical grounds. Today there is a mass of practical and empirical evidence to draw on. It is this evidence which has led most countries around the world to go down the privatisation road.

There is no need to spend time rehearsing at length the benefits of privatisation to this audience. They were well summarised in the recent Treasury briefing paper. The standard result from almost all studies is that while gains can be made from running state enterprises at an arm's length from central government, further gains can be made from privatisation. As one major study put it, "ownership does matter for both technical and allocative efficiency".<sup>4</sup> Large scale studies by the World Bank have confirmed that private ownership is a significant determinant of economic performance.<sup>5</sup>

Similar evidence is now available for New Zealand. A study of Telecom concluded that the annual gains to the New Zealand economy from its restructuring are now

<sup>4</sup> Vining, A R and Boardman, A E, 'Ownership versus Competition: Efficiency in Public Enterprise', *Public Choice*, Vol. 73 (1992), pp. 205-239.

<sup>5</sup> World Bank, *World Development Report 1996*, p. 49.

running at around half a billion dollars.<sup>6</sup> It also found that productivity gains in Telecom since privatisation have been at least as large as those during its period as an SOE and that consumers have received the bulk of the benefits, largely through real price reductions. Without doubt, studies of companies like Air New Zealand and Tranz Rail would also show spectacular gains. In addition to the benefits to consumers, owners have benefited from higher returns, and the government has benefited from much higher tax payments – an additional \$100 million annually in Telecom's case. There have been environmental benefits as well.

Clearly, logic and evidence cannot explain the resistance to privatisation that is still apparent in New Zealand. What then are the explanations?

I think the answers fall under two headings: ideological attitudes on the one hand, and misinformation and misunderstanding on the other.

We have to remember why governments became involved in running nationalised industries in the first place. A hundred and fifty years ago, governments by and large saw their job as being to provide public goods, not to run businesses. Major new industries of the time such as railroads, electricity and telecommunications were all developed privately. But under the influence of Marx and later the Fabians, who naturally could point to faults in a world that will never be perfect, governments began to think they could do a better job of running many businesses than the private sector. To varying degrees they took them over – in the Soviet Union they nationalised practically the whole economy.

The socialist vision has remained powerful for much of this century. It was expressed, for example, in Clause Four of the British Labour party's constitution, which was printed on the back of every member's party card:

To secure for the workers by hand or by brain the full fruits of their industry, and the most equitable distribution thereof that may be possible upon the basis of the common ownership of the means of production, distribution and exchange, and the best obtainable system of popular administration and control of each industry or service.

Tony Blair had to engage in a monumental struggle as recently as two years ago to persuade the British Labour party to drop Clause Four. He was aided by the fact that even the Fabian Society in Britain has been forced to acknowledge the success of privatisation.

Experiments in state ownership have been a failure almost everywhere they have been tried. At worst, as in the Soviet Union, they have led to famines, grinding poverty and brutal coercion. At best, as in Britain and New Zealand, they took the form of state enterprises characterised by poor and costly services, chronic losses, union monopolies and arrogant attitudes towards consumers. In the light of these experiences, as Lord Robert Skidelsky, the author of *The World After Communism*, has put it:

... governments in developed and developing countries alike have been privatizing their public sectors and shredding their instruments of intervention and control. The aim of economic reform is remarkably similar everywhere: a market economy based on private ownership, with accountable governments limited to relatively few functions.

<sup>6</sup> de Boer, David and Evans, Lewis, 'Government Department to Public Corporation in a Deregulated Economy: The Economic Efficiency of New Zealand Telecommunications', mimeo, 1996.

But the ideological nostalgia for common ownership lives on in New Zealand, especially among the older generation. More than most other western countries, New Zealand embraced state socialism, and adherents can still be found in the newspapers every day. Thus Alliance candidate Patrick Mooney tells us that "the Business Roundtable will not be satisfied until the few remaining people's assets (*sic*) are sold off." Productions like the Frontline 'For the Public Good' television programme and the ridiculous film 'Someone Else's Country' are still being made by the ideological Left. An Auckland church leader solemnly told me last year that he thought privatisation was a plague that had suddenly hit the world. Brian Easton has come round to approving commercialisation, but I suspect he will go to his grave denying that privatisation offers greater benefits. There is nothing that can be done about such people. Their resistance to privatisation is ideological. It will not be shaken by logic and evidence. We must concentrate on those whose minds are open to reasoned argument.

What, then, are the sources of misinformation and misunderstanding that trouble open-minded people? Let me deal briefly with a short list of them.

First, some may be influenced by the claim that 'greedy businesses' just want to get their hands on 'cheap assets'. But investors in New Zealand and abroad have access to a worldwide market for existing business assets and new investment projects. There's no reason why they should have a special interest in New Zealand state enterprises. All of them have been sold through open and competitive sales which produced fair value for taxpayers. Like any range of investments, many have turned out well after the event for their new owners while some clearly did not justify the sale price. That's business.

And for those who are hung up on this issue, there is a further response. With market sales, the proper use of proceeds is to return them to the true owners of the businesses, taxpayers or ratepayers, through debt or tax reductions. An alternative, widely used in Russia and some other countries that have divested state businesses, is simply to give shares in the business directly to taxpayers or ratepayers. Those who go on about 'greedy businesses' are remarkably silent about their objections to this approach. I suspect the reason is that, contrary to their rhetoric about democratic decision making, they are not enthusiastic about the idea that people should actually be allowed to make investment decisions for themselves, and want to maintain political control instead.

Secondly, many politicians like to say that they are doing a good job with their SOEs and Local Authority Trading Enterprises (LATEs): they are now running efficiently and making money. Why privatise? We have already seen the answer: privatisation offers further gains. The reasons are elaborated in a recent study by Professors Barry Spicer, David Emanuel and Michael Powell of Auckland University:

Privatisation can be viewed as a means of further economising and locking in future gains by strengthening incentives, opening up access to capital, and subjecting stock-exchange listed companies to equity market disciplines, including the market for corporate control.<sup>7</sup>

They also make the point that, over time, politics typically intrudes on commercial decision making in publicly owned businesses. On average, private businesses perform better, and politicians should not bet against the odds.

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<sup>7</sup> Spicer, B, Emanuel, D and Powell, M, *Transforming Government Enterprises*, Centre for Independent Studies, Sydney, 1996, p. xi.

Thirdly, some people oppose privatisation on the grounds that some publicly owned businesses are monopolies. For example, Harry Julian of the ARST is on record as opposing the sale of the Auckland port company on the grounds that it is a monopoly. But monopoly is an issue of market structure, not ownership. It should be dealt with by removing all artificial barriers to competition, by applying the disciplines of the Commerce Act 1986, and by supplementing them with disclosure or other limited regulation in exceptional cases. In fact it has been clear since corporatisation that there is plenty of competition in the ports industry, and no new issues arise with privatisation – indeed Ports of Auckland Limited is already partly privatised. The Treasury has noted that among existing SOEs only Transpower and parts of the Airways Corporation pose significant monopoly problems. These problems are not insuperable, and it is noteworthy that the Airways Corporation and Ports of Auckland, as well as New Zealand Post, are among the highly successful companies that have publicly stated that they believe they could do an even better job if privatised.

A fourth argument that is still heard is that prices will go up with privatisation because the businesses will have to pay dividends and tax. At base, this is another of the legacies of socialism and the distaste for the profit motive: the belief that goods and services would be cheaper if firms did not have to make profits. Experience has shown that goods and services are produced most cheaply by firms seeking profits in competitive markets, and privatised businesses are no exception. Even more fundamentally, there needs to be a normal return on capital in any investment, regardless of whether it is in the public or private sector, if society's resources are to be allocated to their best use. The profit element is not removed by nationalisation and the true cost of the product or service cannot thereby be lowered: all that can happen is that someone else pays for it. So this argument too is without any substance.

The fifth and final argument that I will deal with is that privatisation worsens a government's financial position. Today this argument is only heard at the local government level. For example, Alister James, Chairman of Christchurch City Holdings, was recently quoted as saying that selling assets would have a "longer term disadvantage in loss of dividend income", with the implication that rates would have to rise. This argument is self-evidently wrong. While a council loses a dividend stream with an asset sale, it also loses a debt servicing obligation, and because the sale price will incorporate the higher expected earnings stream of the asset under private ownership, the council's financial position will improve. It is hard to credit that this argument still has strength given the contribution which privatisation has made to lowering central government's debt and taxes and strengthening its financial position.

These are some of the persisting core issues about privatisation that are surrounded by misinformation and confusion. There are other objections, such as privatisation creates unemployment, that control of 'strategic' assets will be lost to foreigners, that social objectives will be sacrificed, that 'necessities of life' should not be privatised and so forth, which I have discussed elsewhere.<sup>8</sup> And I have not mentioned a number of other benefits of privatisation which have become more apparent over the years, such as the benefits to firms of being set free to pursue long-term and international business strategies; the creation of global opportunities for firms and professional advisers to capitalise on New Zealand's privatisation experience; the deepening of the New Zealand capital market with benefits for superannuation funds and other investors; and the freeing of the time of central and local government politicians to concentrate on their core roles. A fuller discussion of privatisation should also include the many forms it can take other than divestment of government assets, such

<sup>8</sup> See, for example, Kerr, R L, 'The Case for Accelerating the Privatisation Programme', AIC Conferences Crown Enterprise Summit, 28 October 1993.

as competitive tendering for services, contracting out, and a range of options for private involvement in infrastructure provision.

My conclusion is that if New Zealand is to resume an active programme of privatisation – as urged by the OECD, most New Zealand business organisations and, I suspect, most of the government's departmental advisers – there will have to be a great deal more public discussion both of the benefits of privatisation and public misconceptions about it. The silence on the issue is deafening. Where are the academics and business leaders pointing out the benefits of privatisation? Why does the National party project itself as a private enterprise party when its long-term record – from the time Radio Hauraki had to go to sea to force the issue of private radio to the present day – is one of words not matching deeds? If, as the government argues, selling eight small power stations is a good idea, why wouldn't selling eight big ones be an even better one? As the party purporting to represent the lower income sector, why is Labour not pointing out the benefits of privatisation to consumers and promising more, as Labour leader Tony Blair is doing in Britain? He has been contemptuous of:

... those Labour diehards who went on arguing for nationalisation and statism long after their irrelevance was plain to the rest of the world.

And when did we last hear from the Consumers Institute on privatisation? It is little wonder that privatisation is often perceived as unpopular in New Zealand when the field is left to those who spread myth and misinformation.

It is not just politicians who come out with knee-jerk reactions against privatisation; some media commentators, for example, are equally guilty. Two years ago the New Zealand Business Roundtable published a report on the Fire Service which canvassed a range of options for improvements to one of the worst-run government organisations, including a brief discussion of options for private provision. It was greeted with a vitriolic editorial by the *Evening Post*, which advised its readers that:

The Fire Service is already in the process of painful reform, and should get on with the job without the attentions of Business Roundtable types. Targeting service industries and a fixation with costs is a hallmark of Roundtable thinking. It seems to have a curious interest in turning New Zealand into a no-State laboratory, where social responsibility is anathema and no one takes obligation or responsibility for anything.

Apart from the extraordinary suggestion that a country where the government spends one third of national income is a no-state laboratory, the editorial showed an appalling ignorance of fire service issues. Our report had much in common with the independent McCaw report of 1993, commissioned by the Fire Service itself, whose recommendations have never been taken up. In respect of private options, anyone who knows anything about fire services would be aware that half of Denmark's fire services are provided by a private company, Falck, which also operates internationally, and that the ratio of the costs of fire services to GDP in Denmark is about half of New Zealand's ratio of costs to GDP.<sup>9</sup> There are many other examples of private fire service provision. To be fair, in more recent editorials the *Evening Post* has been critical of the Fire Service's performance. However, it has yet to recognise that the so-called "painful reforms" have come to nothing; that the Fire Service's budget is again blowing out; and that nothing will change until the kind of reforms canvassed in our report and the McCaw report are implemented. And newspapers are not very good at saying 'sorry' for getting things wrong.

<sup>9</sup> New Zealand Business Roundtable, *The Provision and Funding of Fire Services: Some Broader Perspectives*, New Zealand Business Roundtable, 1995.

What is particularly galling about the fire service example is that this year the government of the state of Victoria, Australia, has been looking at privatising or contracting out part of Melbourne's Metropolitan Fire Brigade. It has been doing so on the basis of a report by the accounting firm KPMG, presumably yet another 'New Right' organisation committed to a 'minimalist state'. Victoria has been pursuing a vigorous privatisation programme with strong public support, and there is no sign that it is stopping. The huge City Link private roading project in Melbourne is now well underway, two ports have been sold, most of the electricity generation sector has been privatised, and the Kennett government has just announced plans to privatise the state's high voltage electricity grid, PowerNet Victoria, by the end of this year.

Elsewhere in Australia there are similar moves. Qantas has been privatised. The banking sector is now mostly in private hands with the sale of the Commonwealth Bank and most state banks in recent years. The Federal government has commenced the sale of Telstra and plans to sell its rail and shipping interests and the major airports. Australian governments are ahead of New Zealand with reforms in roading and water, including forms of privatisation. And, as in many other countries, reforms are now moving into the area of social services. The Commonwealth Employment Service is being contracted out. The *Australian Financial Review* reported in February that "the idea of privately run prisons is gaining strength in Australia",<sup>10</sup> and the Court government in Western Australia is committed to continuing with the privatisation agenda that marked its first term, with particular reference to hospitals.<sup>11</sup>

What makes these Australian examples even more mortifying is that Australia is far from being a leader in privatisation or microeconomic reform generally. Today the pace is being set by Chile, many countries in Asia, a number of state governments in the United States – Michigan, for example, has recently privatised its workers compensation scheme – and some countries in Eastern Europe. Many commentators in Australia are frustrated that its governments are not doing enough. But Australia provides a measure of how far New Zealand has fallen behind the pace. As an Australian said at a recent conference I attended: "I'd heard about all these reforms going on in New Zealand but I've lived here for three years now and nothing has happened."

The parties to the coalition government have an ambitious vision for New Zealand. The National party has set itself the target of achieving 3.5–5 percent annual growth to the year 2010, and New Zealand First aims to achieve 6 percent growth by 1999. Such targets are feasible, but only if reforms are pushed ahead: there is not the remotest chance that sustainable growth of anything like 5–6 percent a year will be achieved on present policies. All the government's economic advisers will be telling it that any strategy for achieving such goals must include a vigorous programme of privatisation.

Sustained economic growth is the only feasible means for any country to improve overall living standards. On present trends, Australia is likely to achieve higher growth than New Zealand in the foreseeable future. If New Zealanders want to vote against privatisation and other policies which will make them stay relatively poor, I have no problem with that as a matter of democratic choice. But they should realise what they are doing, and they should not complain when Australian living standards far outstrip ours and when most of our young and enterprising people are 'over there'.

<sup>10</sup> 'Privatised prisons are a matter of conviction', *Australian Financial Review*, 27 February 1997.

<sup>11</sup> 'Court pledges agenda for WA prosperity', *Australian Financial Review*, 17 January 1997

**SUBMISSION BY THE  
NEW ZEALAND BUSINESS ROUNDTABLE**

**1997 BUDGET POLICY STATEMENT**

**MARCH 1997**



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## EXECUTIVE SUMMARY

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- The fiscal strategy outlined in the 1997 Budget Policy Statement (BPS) is, in the New Zealand Business Roundtable's (NZBR) view, inconsistent with the government's objectives for economic growth and international competitiveness.
- The NZBR submits that if New Zealand is to achieve its potential, an economic strategy involving substantial reductions in government spending and taxation, flatter tax rates, an active privatisation programme and further deregulation is required.
- Instead the BPS foreshadows greatly increased spending, higher taxes (due to the deferral of the tax cuts), continued government ownership of many trading enterprises, no action on statutory monopolies, and the possibility of extensive regulation of retirement savings.
- The programme set out in the BPS will reduce New Zealand's growth prospects relative to its potential. Lower growth can only exacerbate the problems associated with an ageing population.
- The most fundamental problem is the failure to control government expenditure. In contrast to the government's target of reducing operating expenditures to below 30 percent of gross domestic product (GDP), the last three years have seen progressive and substantial upward revisions in the projected ratios. The target looks further away each year. New Zealand businesses are having to compete with firms in countries where the ratio is less than 20 percent of GDP and which have correspondingly lower tax burdens.
- A major factor in New Zealand's strong rate of economic growth from 1991 to 1995 was the reductions in the scope and size of government through deregulation, privatisation and expenditure control.
- In the NZBR's view, it is no coincidence that the recent economic slowdown has occurred at the same time as the rise in government expenditure. This is a significant source of the cost increases which are putting pressure on monetary policy and thereby the real exchange rate.
- Other factors within the government's control which are contributing to the rather mediocre economic outlook include the growth in meddlesome regulation of the private sector, the reluctance to expose state activities to greater competition and the standstill on privatisation of government-owned businesses.
- The debilitating trend towards increased state spending and greater regulation is epitomised by the government's plans to hold a referendum on whether to introduce a compulsory superannuation scheme while reducing its own savings.
- The suggestion in the BPS that tax cuts should be conditional on a compulsory savings scheme has no logical basis. The longer the government delays reductions in spending and taxes the greater the future difficulties it will face. Demographic factors are projected to increase spending on health and superannuation by 10 percent of GDP in a 40-year period from the year 2000.

- In contrast, vigorous action to reduce general government spending to 20 percent of GDP or below by, say, 2005 through a combination of specific cuts in programmes and measures to increase economic growth would allow large reductions in taxes and greater reliance on personal savings and private insurance as the population ages.
- The move to the 1-3 percent target range for inflation appears to have increased inflationary expectations amongst bond investors by 0.5 percent per annum, and New Zealand businesses and households are now facing higher costs of borrowing as a consequence. Unless the new range can be justified by a principled public policy argument, the previous 0-2 percent range should be reinstated.
- The NZBR also suggests that pensions and other benefits should not be indexed for movements in the consumers price index which simply reflect measurement errors; fiscal risks should be reduced by divestment of assets; and a more meaningful long-term target for Crown net worth should be established.

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# 1 INTRODUCTION

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- 1.1 This submission on the Budget Policy Statement (BPS) is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall New Zealand interests.
- 1.2 This is the third BPS issued under the Fiscal Responsibility Act 1994 (the Act). In submissions on the two previous BPSs, the NZBR reaffirmed its support for the framework for fiscal management provided by the Act. We also supported the previous government's intentions to use increased revenue from economic growth first and foremost to generate operating surpluses, reduce debt and build net worth.
- 1.3 In our submission on the 1995 BPS we commented critically on the government's reliance on revenue growth for meeting its fiscal targets and expressed the view that more modest revenue growth and real expenditure reductions would better achieve its goals of promoting economic growth and social cohesion. We reiterated that view with greater urgency in our submission on the 1996 BPS, concluding that:

... the current trend in government non-finance expenditure is inimical to the government's high economic growth and social cohesion objectives. More vigorous action to reduce expenditure, sell assets, deregulate important areas of activity and move to a flatter income tax structure would increase New Zealand's competitiveness, reduce dependency on the state and foster self-reliance.
- 1.4 Developments in the last year have heightened our concerns. In the first BPS, the then government set a long-term target of reducing operating expenses to below 30 percent of gross domestic product (GDP). Despite this target being reaffirmed in each successive BPS, projected operating expenses have progressively increased as a percentage of GDP. For example, the 1995 BPS projected a ratio of 30.5 percent for 1997/98. This was increased to 32.2 percent in the 1996 BPS and then to 33.4 percent in the 1997/98 BPS. The long-term target no longer looks within reach even by 1999/00 when the ratio is already projected to be 32.1 percent of GDP.<sup>1</sup>
- 1.5 Section 2 of this submission elaborates on the view that a tighter expenditure strategy is needed to achieve the government's macroeconomic objectives. The question of what might be a desirable target for government expenditure is considered in section 3. Section 4 comments on some other aspects of the BPS.

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<sup>1</sup> The ratios in the 1997 BPS are inflated to the extent that some of the measures in the coalition agreement result in revenue reductions rather than expenditure increases.

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## 2 THE CASE FOR LOWER EXPENDITURE

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- 2.1 The previous government's success in turning a large operating deficit in 1990/91 into a substantial surplus four years later reflected two factors. First, it was able, through economic growth, to raise \$5.2 billion more in Crown revenue in 1994/95 than in 1990/91. Tax revenues are running at around 35 percent of GDP and have risen 35 percent in dollar terms in the last four years, according to the 2 December 1996 Economic and Fiscal Update. Secondly, the government was able to hold the increase in non-finance expenses to \$1.1 billion, while financing costs fell by \$1.5 billion.
- 2.2 In sharp contrast, in the five years to 1999/00, real non-finance annual operating expenses are projected to rise by 15.7 percent, or \$4.2 billion, from \$26.6 billion to \$30.8 billion (see the following table). Operating revenues are projected to rise by a further \$1.4 billion in real terms during the same period.
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### The Lift in Real<sup>(1)</sup> Non-Finance Expenses (GDP Deflator)

	1994/95 <i>Actual</i>	1998/99 '96 Budget	1998/99 '97 BPS	1999/00 '97 BPS	1999/00 % Increase 1994/95
Total Real Operating Expenses (\$bn) <sup>(2)</sup>	30,400	30,670	32,339	32,565	7.1%
Finance Costs (\$bn)	3,757	2,217	1,970	1,729	-46.0%
Real Expenses Less Finance Costs (\$bn)	26,643	28,453	30,369	30,835	15.7%
Non-Finance Expenses (% of GDP)	30.7%	28.9%	31.0%	30.4%	

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#### Notes:

(1) Base 1994/95 prices.

(2) Derived from the GDP deflator implicit in the 2 December 1996 Economic and Fiscal Update, the 1997 BPS and the 23 May 1996 Budget Economic and Fiscal Update.

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- 2.3 There are several concerns here:

- the government's additional spending commitments are not conditional on the achievement of the revenue projections;
- the \$4.2 billion real increase in non-finance spending undermines the effort put into curtailing the growth in government expenditure in the first half of the 1990s and represents a significant increase in average tax rates, compared with what might otherwise have been achievable;

- the quality of the additional spending appears to be low – where it is on transfer payments it will tend to benefit higher income earners and where it is on goods and services it tends to be in areas in which arguably a smaller rather than a larger government role would improve outcomes. Examples of decisions with a clearly regressive effect, in that they disproportionately benefit higher income individuals or families, are the proposals on universal student allowances, the superannuation surcharge, and free doctor visits for children under five;
  - the announced expenditure increases maintain the disincentive effects of the existing tax system compared with the alternative of reducing tax rates; and
  - weaker fiscal discipline is likely to undermine business and consumer confidence.
- 2.4 The NZBR's major concern is that higher spending will fuel inflation in the sheltered sectors and reduce growth in the exposed sectors of the economy. Statistics compiled by the Reserve Bank make it abundantly clear that inflation emanating from property prices and the sheltered sectors of the economy is forcing the Reserve Bank to keep interest rates (and therefore the real exchange rate) higher than would otherwise be necessary. High interest rates and a high real exchange rate are undoubtedly squeezing the profitability of internationally competing industries and contributing to slower economic activity and reduced business confidence. Monetary policy impacts particularly on investment and the traded goods sector of the economy, whereas the impact of fiscal policy tends to fall on consumption and the non-traded goods sector. Monetary and fiscal policies need to be better harmonised.
- 2.5 We believe that the greater fiscal discipline established in the 1991 budget was crucial to New Zealand's economic recovery and growth. Far from deepening the recession as predicted by many Keynesian-oriented economists at the time, it reduced the pressure on monetary policy and provided room for the private sector to expand. Fiscal policy, including asset sales, aided social policy by contributing to economic growth, job creation and self-reliance.
- 2.6 In contrast, the rate of economic growth has slowed as non-finance government expenditures have increased and the pace of economic reform and privatisation has slowed.
- 2.7 Higher spending necessarily means higher taxes now or in the future. Government operating expenses are projected to remain appreciably above 30 percent of GDP. This is well above the levels in many of our better-performing trading partners and much higher than it was in the decades up to the 1970s when New Zealand achieved a more satisfactory economic performance.
- 2.8 Further, the burden of the additional spending seems likely to fall disproportionately on sections of the population and industries on which the government is relying for increased economic growth. For example, the burden of funding higher transfer expenditures to the aged is likely to fall largely on the working-age population. The workers in question will be distributed between the exposed and sheltered sectors. However, the exposed sectors are particularly at risk when government expenditures are increased on sheltered sector activities (such as education and health) since they are likely to gain resources at the expense of internationally competing industries.

- 2.9 The competitiveness of the traded goods sector can also be harmed by regulations which impose excessive costs. Cost increases from the Accident Rehabilitation and Compensation Insurance Corporation scheme and from the large increase in minimum wages fall into this category. Other sectors in which dominant suppliers enjoy state protection from competitive forces include New Zealand Post and the single desk producer boards.
- 2.10 A further concern is that the BPS is based on economic growth projections which fall well short of New Zealand First's target of 6 percent annual growth by 1999/00 and the projected growth rates of many of our trading partners. For the next three years projected growth is also below the bottom end of National's 3.5 - 5 percent target range to the year 2010.
- 2.11 This concern is compounded by the possibility that these forecasts might be too optimistic. For example, the average of the forecasts surveyed by the New Zealand Institute of Economic Research in December 1996 revealed a profile for GDP of 1.8 percent, 3.0 percent and 3.1 percent for 1996/97, 1997/98 and 1998/99 respectively. In contrast, the projections in the BPS are based on GDP forecasts of 2.6 percent, 3.6 percent and 3.1 percent respectively. Lower than forecast economic growth is likely to result in reduced revenues, smaller reductions in debt, higher interest expenses and higher expenses on social welfare benefits.
- 2.12 For these reasons we do not see how the government can avoid the conclusion that current policies will not produce satisfactory outcomes, either relative to the economy's potential or relative to the growth aspirations of both parties to the coalition. In our view the problem is not that the goals are undesirable or unachievable; rather it is that current policy settings make them unrealistic.
- 2.13 The same point can be made in respect of the projections for the rate of unemployment which underlies the BPS. According to these projections, the rate of unemployment will remain at or close to 6 percent through to 1999/00. In our view such an outcome would be extraordinarily wasteful and entirely unnecessary. The better-performing Asian countries have demonstrated that very low rates of unemployment are achievable with flexible labour markets and strong growth. New Zealand's own experience from 1991 to 1995 demonstrated that rapid economic growth and the more flexible labour market created by the Employment Contracts Act 1991 can dramatically reduce unemployment. We concur with the widespread view that weaknesses in the Act have allowed successive Employment Court decisions to reduce the efficiency of the labour market and the rate of job creation. These weaknesses can be readily rectified by a government with a will to do so. We also believe that many other statutes, such as those relating to holidays, minimum wages and workers' compensation, are unduly inhibiting employment.
- 2.14 The unsatisfactory outcomes from much existing expenditure are a further source of concern. Community welfare is reduced if government spending is wasteful, for example if the government uses taxpayers' money to buy health and education services on behalf of those same taxpayers, but only produces 90 cents of value for each dollar taken. There are many reasons why governments tend to spend taxpayers' money less wisely than taxpayers themselves.
- 2.15 Even when government spending is well directed, the opportunity costs of a dollar of such spending are higher than for private spending. The most commonly recognised costs comprise the costs of tax collection, administration, enforcement and compliance. While compliance costs cannot be accurately measured, one study found that the costs of complying with business taxes were about 2.5 percent of GDP. The same study found that the

cost per dollar of complying with business taxes was over two and a half times the cost per dollar of complying with GST.

- 2.16 A further economic cost arising from taxation takes the form of people altering their behaviour in unintended and undesired ways in response to the disincentives created by taxes. For example, they might work fewer hours, opt for a lower-paying job, fail to seek promotion, work and invest for capital gains rather than income, and/or organise their affairs so that income accrues to a family member on a lower tax rate. Economists refer to such costs as the 'deadweight' costs of taxation.
- 2.17 While such costs obviously defy precise measurement, research suggests that they can be very high. Marginal tax rates (income tax at 33 percent plus GST of 12.5 percent) are much higher for many taxpayers than is the ratio of government expenditure to GDP. A study commissioned by the NZBR found that each additional dollar raised in taxation costs the community a further 14-18 cents (that is, national income is lowered by that amount). Higher estimates, of 25-146 cents for each additional dollar of taxation in 1988, have been derived by Paul McKeown and Alan Woodfield at the University of Canterbury. With tax revenues running at around 34 percent of GDP throughout the forecast period, such estimates strongly suggest that government spending and taxation is imposing a heavy and ongoing cost on the community.
- 2.18 In addition, costs arise as individuals organise their affairs so as to make themselves eligible to receive benefits, for example under transfer programmes. Political lobbying to enhance the range of benefits and to extend its scope represent the expenditure of real resources on what is a non-productive activity from the viewpoint of society as a whole. While such costs are difficult to measure, they may be significant.
- 2.19 Universal transfer programmes are costly and impose large tax burdens. Taking money from people simply in order to give it back to the same group wastes resources. On the other hand, transfer programmes which take from some in order to give to others necessitate targeting. Targeted transfer programmes induce members of the target groups to change their behaviour so as to avoid taxes and gain benefits. Such costs impose a burden of proof that transfer programmes generate commensurate benefits for society.
- 2.20 In addition to reducing deadweight losses, tax reform involving lower, flatter income tax rates would also reduce the difficulties currently caused by the tax structure in the areas of income testing, income splitting, international taxes, capital gains taxes, trusts, superannuation funds and forestry. We welcome the Treasurer's recent statement foreshadowing possible reductions in business taxes. In our view a lowering of all high marginal rates of tax would have major economic benefits.
- 2.21 This section has outlined the immediate case for reducing rather than increasing spending. The next section considers the issue of a longer-term target for government spending.



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### 3 A LONGER-TERM TARGET FOR OPERATING EXPENSES

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- 3.1 The growth in the size of government in New Zealand since late last century mirrors developments in the United States and most European countries. As summarised in an article in *The Economist* of 6 April 1996, government spending in the industrialised countries was around 8 percent of GDP in 1870, rose with World War I and rose again with the Great Depression to reach almost 21 percent of GDP by the late 1930s. Even so, the biggest rise in government spending took place with the expansion of the welfare state which followed World War II. This expansion saw the ratio rise to 43 percent of GDP by 1980. The growth in the size of government in the New Zealand economy followed a broadly similar pattern.
- 3.2 The research by two International Monetary Fund (IMF) economists<sup>2</sup> which forms the basis of the article mentioned above found evidence that countries which had the lowest increase in public spending since 1960 appeared to be more efficient and more innovative, and enjoyed a lower level of unemployment and had much smaller 'black' economies. Nor did the wealthy industrialised countries appear to have significantly superior figures for school enrolment, life expectancy or infant mortality than newly industrialised countries where spending averages only 18 percent of GDP. The authors concluded that rising public spending since 1960 has delivered few social benefits and, in some cases, has harmed economic performance.
- 3.3 Reflecting on what might be done in response to the evidence that increased government spending in the industrial countries since 1960 had not improved outcomes, the IMF authors observed that:
- Cutting back the welfare state in a careful and well-planned way that preserves basic social and economic objectives could yield significant budgetary savings while still providing essential social safety nets and basic social insurance. ... A major rethinking of public expenditure policies is therefore necessary.
- They suggested that governments should be thinking about reducing state sector spending to the proportion of GDP prevailing 30 years ago.
- 3.4 In the late 1960s central government non-finance current spending in New Zealand was around 21 percent of GDP. Today non-finance Crown account *current* spending is around 28 percent of GDP on an SNA basis and around 31 percent on a GAAP operating expense basis. The 28 percent ratio is split equally between central government spending on final consumption and Crown spending on transfer programmes.
- 3.5 Thirty years ago Crown spending on social security benefits and pensions was only 6 percent of GDP. There is no obvious intrinsic reason for the sharp rise in such spending. For example, the chart on p. 19 of the BPS indicates that the ratio of those aged 65 and above to those aged 15 to 64 has only increased

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

marginally during this period. The rise in per capita incomes since the 1960s ought to have reduced, rather than increased, the need for other welfare spending.

- 3.6 New Zealand governments are now spending over 12 percent, or more than twice the 1960s percentage, of a much higher level of GDP<sup>3</sup> on social welfare for greatly inferior outcomes in terms of crime, schooling, family break-up, inadequate parenting and allegations of poverty and/or state dependency. A plausible case has been made by scholars such as Charles Murray and Thomas Sowell that the welfare programmes which many industrialised countries have pursued in recent decades have themselves contributed to such outcomes and that more spending will exacerbate many of the problems. In our view this case has not been adequately rebutted by the advocates of current policies in New Zealand.
- 3.7 In a report entitled *Moving into the Fast Lane* (March 1996), the NZBR, in association with the Auckland and Wellington chambers of commerce, advocated an interim medium-term goal of reducing total (central and local) government spending to below 20 percent of GDP by 2005. We are still firmly of the view that reductions in tax burdens of this order are necessary if New Zealand is to reach its full growth potential. This judgment is based on the evidence of the unsatisfactory outcomes of heavy government involvement in such areas as health, accident compensation, education and social welfare, on contemporary cross-country comparisons, and on the historical record. The case for such a target is strengthened by the ageing of the population which is emphasised in the BPS.
- 3.8 Some empirical research posits a relationship between economic growth and government spending as a percentage of GDP and estimates that the growth-maximising spending ratio is about 20 percent.<sup>4</sup> This reinforces other evidence that an overly large public sector inhibits innovation and growth, although we suspect such an estimate is too high. First, we do not see why government spending as a ratio of GDP should be independent of a country's population, demographic structure, and other characteristics. Some spending should surely fall in relation to GDP as the country grows. Second, in our view, government expenditure should ultimately be determined by expenditure-by-expenditure analyses of the value for money associated with government programmes, taking the costs of raising taxes into account. Top-down approaches fail to do this. It is hard to see that government spending on genuine public goods and a well designed social safety net would amount to 20 percent of GDP in a well functioning, high income economy.
- 3.9 Spending on health, education, social security and welfare currently account for 80 percent of non-finance Crown operating expenses. The private sector is well placed to provide health, education and disability insurance services. In our view consumers would derive major benefits in these areas from privatisation of the supply of such services and greater competition. The size of the state sector would be further reduced if people who are not regarded as being in need were allowed to spend their own money on these services directly, rather than have the government raise tax revenue and spend it for

<sup>3</sup> Data in Table 1 of the Annex to the OECD's Economic Outlook, December 1996, indicate that real GDP in New Zealand increased by 67 percent between 1969 and 1996.

<sup>4</sup> For example, Scully, Gerald, 'What is the Optimal Size of Government in the United States?', National Centre for Policy Analysis, Report No. 188, November 1994, Texas, pp. 1-15; and 'Taxation and Economic Growth in New Zealand', Pacific Economic Review. 1:2 (1996), pp. 1-9

them. There is ample scope here for substantial reductions in government spending relative to GDP. In the case of welfare, the challenge for the future is to find a system which provides better incentives for responsible behaviour and the preservation of viable family structures and support systems. It seems likely that this will require a shift towards greater personal, family and community responsibility, with the state undertaking a role of last rather than first resort.

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## 4 OTHER ISSUES

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### Economic and Social Priorities in the Budget Policy Statement

- 4.1 The government's economic and social priorities are set out on pp. 5–6 of the BPS. The priority aims of achieving a strong economy through low inflation, lower taxes, reduced public debt and prudent and conservative fiscal management are strongly supported by the NZBR and, we believe, the business community in general. Many other objectives concerning the family unit and care for others also clearly command support.
- 4.2 By contrast, questionable priority is given to "increasing the national savings rate by the most effective means possible". First and foremost, there is no reason to believe that the government possesses the information necessary to determine the 'right' level of national savings. A higher savings rate is not necessarily favourable for economic growth, let alone for general community well-being. New Zealand's national savings rate has long been around the Organisation for Economic Cooperation and Development (OECD) average. It has been well above that of some more successful economies, notably the United States, and well below that of some successful Asian countries. How can the government know in which direction it should move?
- 4.3 Second, the national savings rate is outside the government's direct control.<sup>5</sup> All it can do is alter its own savings behaviour and people's incentives to save for themselves. The most direct way the government might hope to increase the national savings rate is to increase its own savings. Paradoxically, the decisions foreshadowed in the BPS go in the opposite direction by reducing projected operating surpluses. A further way in which the government might improve incentives to save is to reduce the extent to which welfare and superannuation policies reward those who choose not to save. Much could be done here, but the decision to abolish the superannuation surcharge impinges on so few people at the margin that any positive effects on savings may well be offset by the negative effects of the higher implied tax rates for the population as a whole. The government's proposal to introduce a compulsory retirement savings scheme subject to the outcome of a referendum is unlikely to alter the national savings rate for well understood reasons – such schemes basically alter the form in which people make their savings but do little or nothing to raise total savings.
- 4.4 A further objective in the BPS is to provide health and social services with a "particular focus" on those who have problems through "misfortune or bad luck". We entirely concur with the implied view that a fundamental problem with many social policies is that they reward far too much self-destructive and dysfunctional behaviour. The stated objective implies a major restructuring of the welfare state. Currently eligibility for support does not depend on recipients being able to establish that their misfortune is not due to their failure to get a better education, adopt a disciplined lifestyle and work habits, or purchase appropriate insurance policies. The adoption of such a focus would clearly lead to reduced expenditures on welfare, but such reductions are not apparent in the published expenditure projections. Either this objective is simply rhetoric or it has substance. The government's intentions in

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<sup>5</sup> We made similar comment about growth targets for GDP in our submission on the 1996 BPS.

this area need to be clarified. Similarly, in the same section of the BPS, the government's objective of respecting the spirit and letter of the Treaty of Waitangi needs to be clarified. How does the government propose to hold itself accountable for meeting this objective?

- 4.5 Finally, this section states that the government's overall aim is to help people to help themselves and to support them when they cannot. It is not clear what role the government envisages here for support by family, friends, colleagues, societies, private welfare agencies and insurers. The criteria for distinguishing the government's role from these other forms of support need to be clarified.

### **Additional Spending on Education and Health**

- 4.6 The emphasis in the discussion on education and health in the BPS is on greater government provision of services and increases in expenditure. Government provision is often notable for its protection from competition, conflicting and/or poorly specified objectives, failure to offer diversity and choice, and vulnerability to capture by professionals whose concern to improve their own pay and working conditions can conflict with the interests of consumers. All these problems are evident in current arrangements. In many cases there is little evidence that higher spending has improved outcomes. We would urge the government to have full regard to such issues and to consider the case for wider reforms to education and health provision.

### **The Ageing Population**

- 4.7 According to the BPS, as the ratio of those aged 65 years and over to those aged 15 to 64 doubles over the next 40 years, spending on health and New Zealand Superannuation could increase by over 10 percent of GDP. Since the best way of alleviating the burden of an ageing population is through economic growth, such statistics heighten concerns about the adverse effect of the government's proposed economic strategy on the economy's growth performance. Lower and better targeted expenditures and an active programme of asset sales would increase the growth rate of the economy and allow tax rates to be lowered to more competitive levels. At the same time incentives to work, save and invest in skills would be enhanced for the working-age population. Immigration also has a role to play in modifying the demographic outlook.
- 4.8 Given such policies, there is no need to expect the ageing population to be associated with a substantial increase in public expenditures. Greater self-reliance through private savings and the purchase of health insurance and, where desired, later retirement would obviate the need for greater public provision. The provision of real goods and services to people in retirement, however, can only come from the productive activity of those engaged in the workforce, and hence is ultimately dependent on economic growth.
- 4.9 It is disappointing that the BPS does not (see p. 20) have a clear focus on economic growth and options for greater self-reliance. Instead of recognising the degree to which current government policies penalise thrift, work and self-provision and foster reliance on the state, the BPS proposes to expand the state's role by adding all the regulatory costs and barriers associated with a compulsory retirement savings scheme to the other impediments to economic growth. The document expresses the hope that such a scheme could help increase the savings of those who currently make little provision for the future. However, it does not comment on the costs which the regulatory structure

would impose on all other members of society whose flexibility to mobilise funds for education, business and family purposes would be reduced.

### Long-term Objectives

- 4.10 In our view, as explained in sections 2 and 3, the government would have a much better chance of achieving its overall objectives if it aimed to reduce non-finance operating expenses to below 20 percent of GDP while demographic factors permit. This compares with a projected ratio of 30 percent for 1999/00 in the BPS.
- 4.11 The BPS also fails to present a meaningful long-term objective for Crown net worth. The stated objective is to achieve "[n]et worth at significantly positive levels". Currently net worth is at 6.3 percent of GDP (the projected 1996/97 ratio) but this will rise to 13.8 percent of GDP by 1999/00 on the government's projections. We acknowledge that arriving at a meaningful objective for Crown net worth requires considerable analysis. However, clarification of this objective is desirable in the interests of greater accountability for fiscal management on the part of the government and to reduce uncertainty in private decision making.
- 4.12 Given government spending intentions, increases in net worth trade higher current tax rates for lower future tax rates. This is likely to represent an intergenerational transfer of income. Alternatively, if higher current net worth reduces government resistance to pressures for greater spending, such a policy represents a transfer from taxpayers to the beneficiaries of the increased spending, and an increase in the deadweight losses caused by taxes.
- 4.13 The government might be able to provide a more meaningful long-term objective for Crown net worth in the context of a more explicit assessment of the implications of an ageing population for the stability of future tax rates through time (since Crown net worth may be more volatile, the more stable the rates of tax). Such projections should heighten awareness of the sensitivity of future tax rates to policies which opt, for example, for tax-based social insurance for health care costs rather than a private insurance approach. Alternatively, the government may be able to form a less far-reaching view about the optimal longer-term credit rating for sovereign debt or about a prudent debt to net worth ratio for the Crown's balance sheet.

### Fiscal Risks

- 4.14 The section in the BPS on managing risk (pp. 21–22) fails to comment on the management of risks to which the Crown is exposed as a result of its regulatory interventions and its policy of retaining certain 'strategic' assets in public ownership. Examples here include its ongoing ownership and regulation of the ACC, the Earthquake Commission, the major generators of electricity and Trans Power.

### The 1–3 Percent Target for Inflation

- 4.15 ANZ bank economists have recently reported tentative evidence that the recent widening of the target range for inflation has increased nominal bond yields by 0.5 percent per annum, relative to the yield on inflation-indexed bonds.<sup>6</sup> This accords with the intuition that shifting the mid-point of the target

<sup>6</sup> ANZ Market Focus, Issue No 11/97, week ending 20 March 1997.

range for inflation from 1 to 1.5 percent per annum would be likely to lift inflation expectations by 0.5 percent per annum. As a result, New Zealand businesses and households are now likely to face higher costs of borrowing.

- 4.16 The original 0–2 percent target rate for inflation had a clear rationale: price stability was the objective and the mid-point of 1 percent per annum reflected an allowance for the lagged nature of the index and measurement problems in respect of unquantifiable quality improvements in products. In the absence of any technical argument that this mid-point was too low, the increase in this range appears to have no sound basis. If so, surely the decision should be reversed. If, to the contrary, there is a sound public policy rationale for increasing inflationary expectations and nominal interest rates by 0.5 percent per annum, it should be articulated in the interests of transparency, credibility and time consistency.

### **Policy on Indexation**

- 4.17 The discussion on p. 19 of the BPS notes the expenditure implications of the indexation of superannuation payments in conjunction with the abolition of the surcharge. The combination of a price stability objective for monetary policy in the Reserve Bank of New Zealand Act 1989 and the determination of a target range for consumers price index (CPI) inflation of 0–3 percent per annum in the Policy Targets Agreement implies that the government is taking the view that measured inflation of 1.5 percent per annum is consistent with price stability. Given this view, it is incorrect to index superannuation (or other) payments for changes in the cost of living except for any deviation in measured inflation from 1.5 percent per annum.
- 4.18 We see no evidence of any adjustment to government expenditure projections to reflect this point. The longer the government delays responding to this anomaly, the more difficult it will find it to do so at a later date. Over time significant unplanned changes in the real value of superannuation and other payments would occur. We recommend that the government review as a matter of urgency the basis on which it adjusts relevant payments (and taxes) in response to movements in the CPI.

**COMMERCE NELSON LOCAL GOVERNMENT FORUM**

**PROMOTING ECONOMIC GROWTH  
CHALLENGES FOR LOCAL GOVERNMENT**

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

**NELSON  
20 FEBRUARY 1997**



## PROMOTING ECONOMIC GROWTH: CHALLENGES FOR LOCAL GOVERNMENT

Local government doesn't exist in a vacuum: rather it is one means of achieving desired economic and social goals. We therefore need to consider the role of local government in the context of all available options for meeting those goals. We need to assess which tasks it can best undertake and which are best handled in other ways.

Few people now need be convinced that New Zealand's economy is in much better shape as a result of the economic changes of recent years. Many of those changes have involved a rethinking of the role of government in the economy. But there is still much work to be done if we want to attain the living standards of leading countries and deal with outstanding social problems. That will require us to carry on rethinking current ways of doing things in both the public and private sectors, and striving for continuous improvements.

The last National government set itself the goal of an annual economic growth rate of 3.5-5 percent to the year 2010. New Zealand First has a higher target: it is committed to achieving annual growth of 6 percent by the end of its first parliamentary term. Few, if any, economic observers expect any of these goals to be achieved in the next three years on current policies, despite the stronger economy and a favourable world environment. Most expect the coalition's initial package will harm such prospects, particularly through the size and low quality of its government spending proposals. These will exacerbate tensions in the economy and hurt internationally competing industries. It follows that further bold initiatives will be needed if the coalition parties' commitments to high growth rates are to be credible.

Such initiatives must involve local government, whether they originate in central government or the sector itself. Local government is a big player in the economy, in terms of assets, spending, employment and its regulatory role. If it is underperforming in any way – for example by not clearly identifying its proper functions, by becoming involved in extraneous activities, or by not operating at maximum efficiency – then the whole economy suffers. That means citizens in general suffer because, contrary to popular rhetoric, the only purpose of the economy is to meet people's needs.

Of course citizens have other desires as well as an efficient economy, and public policy – including at the local government level – should also be concerned with things like public amenities and the environment. And there are some, such as Tony Simpson, president of the Public Service Association (PSA), who have argued against the idea of an efficient economy and the higher living standards that go with it, saying:

... we have to run a less than efficient economy, because if New Zealand was really running at maximum efficiency there would never be enough jobs for people to do.

This statement is presumably intended as a defence of maintaining inflated payrolls in the public sector, but it is economic nonsense. Resources, including labour, are always scarce relative to people's wants in an efficient economy, as the experience of the high employment economies of East Asia demonstrates. The PSA is perfectly entitled to argue for the acceptance of lower living standards, but New Zealanders seeking increases in wages and other incomes don't seem to share its views.

Fortunately, there is a growing recognition of what local government needs to concentrate on if it is to play an effective part in economic and social development. Let me quote you a relevant passage:

Where should local government be heading over the next 10 years and what is it doing now that causes concern in our community?

To answer those questions, it is helpful to look back at the past and to see where local government has come from in this country.

Originally, communities banded together to provide essential works such as roads, bridges, refuse collection and disposal, water supplies, sewerage reticulation and land drainage. ...

From there, local government developed on the centralist principle of the all-caring, powerful, collective being better able to care for individuals than those individuals would possibly manage for themselves.

Then, in 1989, local government was reformed.

But we still have people in local government who operate on the 'big brother' principle.

These are the councils which ... have committed to the discredited concept of big spending, large government. They are characterised by grand schemes, an almost religious fervour in their strategic planning, and environmental crusades. ...

History tells us that the most likely outcome will be a shameful waste of money. ...

Local government should begin asking the question, what is best for New Zealand and New Zealanders?

The answer may be that there are better delivery mechanisms for works, services and regulatory functions. ...

Indeed, it may be that those services can be delivered better and cheaper outside of local government, thereby removing a layer of cost and bureaucracy from the lives of ordinary New Zealanders.

Contrary to what you might be thinking, that is not an extract from a New Zealand Business Roundtable speech. It comes from an article by the mayor of Papakura, David Hawkins, which appeared in the *Herald* last year. Mr Hawkins has written to us saying he agrees with our general approach on local government but believes it doesn't go far enough. He has questioned whether New Zealand will ultimately need local government at all.

Another council that is regarded as a leader in local government is the Rodney District Council. It has been one of the first to prepare a 10-year financial strategy under the new local government legislation. A section of its document reads as follows:

Some local authorities in New Zealand involve themselves in a very wide range of activities on behalf of their local communities – including things like health and welfare, social and economic issues, subsidised and senior citizen's houses, child care, unemployment, as advocates for children, youth entertainment, art galleries, public relations offices, the provision of convention centres, economic development and marketing, the promotion of local festivals and events, arts and culture, and so forth.

The Rodney District Council has received the very clear message that ... this is *most definitely not* what people want here.

The District Council will continue to confine its work to a very narrow range of activities. It believes that its core business is:

- **TO PROVIDE LEADERSHIP** for the District (especially by way of advocating the District's interests to Central and Regional Government) and to coordinate/empower/support/encourage/facilitate local people and national and local organisations to work together in the local community interest; and
- **TO MAKE PROVISION** for the operation, maintenance and upgrading of local roads, sewerage systems, water supplies, stormwater systems and some recreation and civic amenities; to plan for and administer controls on the adverse effects of land uses in its district; and to exercise a limited number of other regulatory responsibilities.

That approach is broadly in line with our thinking and, I believe, that of most other business organisations. To say that local government should focus on such core functions is not to say that the other activities listed by Rodney District Council are unimportant. It is simply to say that local government is not the best institution to undertake them, and that by over-reaching itself it will be less effective in discharging its core responsibilities. Indeed the best contribution local government can make on issues such as unemployment and economic development is to achieve lower rates, reduce regulatory burdens, and organise efficient infrastructural services so as to encourage private investment and job creation.

A common objection to this line of argument by some in local government who defend a 'big government' role is to say they have popular support. This misses the point. We all want local governments to be democratic, but we also want their policies to be sound. Sir Robert Muldoon's policies enjoyed democratic legitimacy, but they ran the country into the ground. Economic directions changed democratically in New Zealand because the arguments about the failings of Muldoonism ultimately prevailed. Debate about public policies must be based on sound public policy criteria: the fact that a particular course of action enjoys temporary popular backing does not necessarily make it sound.

Another objection to a constrained vision for local government is that councils have to step in to 'fill a gap' or 'meet an unmet need'. As John Roughan put it recently in the *Herald* in a related context:

... you can still find innumerable people who want the government to finance a possum fur industry if nobody else will.

The argument is similar to those which would have businesses assuming all kinds of social responsibilities or schools taking on non-educational roles. If acceded to, the likelihood is that the core functions of all these institutions will not be performed well, activities of marginal social value will be picked up, substitutes for them will be crowded out, and those who should be assuming the relevant responsibilities are let off the hook.

The proper business of local government is not hard to define conceptually. Local government is part of the public sector. By definition it should be involved in organising the provision of public goods. It should not be involved in the provision of private goods. Most goods are private goods: they are bought and sold in the market place, or – in the case of many sporting, recreational and charitable activities – organised voluntarily. A public good satisfies two main criteria. First, is it possible to charge for it? If not, it may be a public good. Second, can people be excluded from

using it? If it is not possible to exclude non-payers, it is less likely that the service will be provided commercially. Open-access parks, footpaths and stormwater drainage are standard examples of public goods at the local government level.

Public goods whose provision must be organised by local government are quite rare. Many councils are now rightly reviewing the services they provide to determine where user charges or part charges are justified. The public good component of services, however, will usually need to be financed from rates.

The vast majority of the assets tied up in local government – roads, water and sewerage, power supply, ports, airports, forests, bus companies, parking buildings and so forth – are used to produce private goods. Roads, for example, are largely funded by user charges and (pedestrians aside) non-payers are excluded. Together with local government regulation, these are the activities that have the largest impact on the business sector and hence on economic growth. For this reason the interest of the business sector in local government is mainly focused on these activities. By contrast, I think business organisations are relatively relaxed about whether councils provide things like community or information services on a modest scale. Especially in small communities, this may well be a sensible role.

Because the 'big ticket' items account for the lion's share of councils' assets and spending, they should obviously account for most of their decision-making time. And because they are largely private goods, questions are clearly raised as to whether councils should remain involved with them. My view is that in most cases there is no longer a need for local government involvement, at least in its present form. Power companies, ports and airports are increasingly being run by the private sector around the world, and there is now substantial private sector involvement in roading and water supply.

The evidence in favour of private ownership and/or management of business enterprises is now abundant and does not need to be rehearsed here. There is a convenient summary in the Treasury's briefing to the incoming government. Given the generally superior performance of businesses under private ownership, there needs to be very strong public policy reasons for keeping them in the public sector. It is not sufficient just to run state-owned enterprises (SOEs) or Local Authority Trading Enterprises (LATEs) on business-like lines; typically there are further large productivity gains with privatisation. Nor is it sufficient to point to the fact that some private businesses fail, and that some SOEs and LATEs have achieved good returns. The relevant point for public policy is that on average and over time the performance of private firms is superior, and politicians should not bet against the odds. It is simply ludicrous for Manukau City, for example, to put ratepayers' money at risk by undertaking a grass-mowing operation in Brisbane.

There is little doubt that New Zealand's economic growth will be stunted in the absence of further privatisation at both the central and local government levels. Some councils are moving in that direction; others which are almost wholly commercial operations, like the Auckland Regional Services Trust, seem reluctant to give up their role.

Some extraordinary arguments are still made about privatisation. A classic was a recent *Otago Daily Times* editorial which concluded that if the Dunedin City Council sold its electricity and forestry assets, rates would be 20 or 30 percent higher. Can you imagine anyone seriously suggesting that if central government sold its electricity or forestry assets, taxes would go up? The future value of the income streams of government assets is capitalised at the time of sale; their present value is typically higher under private ownership because of the expectation that the businesses will be managed more efficiently; the financial position of central or local government is improved as a result; and there is the potential for taxes or rates to go down, not up.

Another objection to privatisation that is sometimes raised is that business simply wants to get its hands on assets and reap the benefits. This overlooks the fact that buyers have to pay full value for assets sold by councils in competitive sales, and that the main beneficiaries of privatisation are consumers and ratepayers. Moreover, while competitive sales are usually the best means of privatisation, we have argued that a good alternative for a council is simply to issue shares in its businesses to their true owners, the ratepayers. Letting them decide whether to remain investors is surely the most democratic of democratic procedures. So forget about so-called 'greedy' businesses: what is the objection to this approach?

Where councils need to ensure that services of a largely public good nature are provided, it is equally well established that there are usually major gains from contracting them out by competitive tender to the private sector. A recent case in point concerns bus services in Auckland. Around 50 percent are now operated on a commercial basis, and the subsidy required in those sectors which went to tender has dropped from \$22 million a year to \$13 million. Wellington City Council is moving to competitive tendering for a wide range of services. Central Hawkes Bay, which has a population of 12,500, makes the greatest use of contracting out in the country and has reduced its staff to 25. If other councils were to achieve the same ratio of staff to population, employment in local government would fall from 38,000 to 7,000, although many of these people would find jobs with private contractors. It is not difficult to understand why Tony Simpson and the PSA defend inefficiency and oppose local government reform. One can also see why excessive local government costs put pressure on the real exchange rate and the traded goods sector.

Yet resistance to such productivity gains is entrenched in some elements of local government. Stuart Macaskill, chairman of the Wellington Regional Council and former president of the then Local Government Association, is one who has repeatedly come up with spurious arguments against privatisation and contracting out. He has even argued that the regional council, which has no comparative expertise in managing forests, can get a better return on its forestry investment by hanging on to it rather than selling it. The logic of the argument would suggest that the Wellington Regional Council should own the entire national forestry estate. Recently Mr Macaskill has opposed the decision by the Wellington City Council to tender out maintenance of its water supply and argued that his council should be given a regional monopoly. Fortunately, the replies by the mayor and other Wellington City councillors were robust: the regional council had been slow to fix leaking pipes, it had done "a lousy job", and "he is trying to protect his patch".

Papakura District Council is moving to franchise its entire water supply and sewage disposal services to a private operator. Stuart Macaskill's last line of argument against such proposals is that 'the public would not wear it'. Yet only eight public submissions were received on Papakura's proposal, and five of them urged the Council to take the next step of full privatisation. This is in line with experience elsewhere with water industry reforms wherever political leadership has been shown. Commenting on Australian experience with user charges for water, the *Australian Financial Review* noted in an editorial last year that "the politics of paying for water ... has never been a significant issue." The average weekly cost of water to a New Zealand household amounts to less than it spends on Lotto and other forms of gaming, and there would be large efficiency improvements with a more commercial approach to water supply.

An interesting question is whether local government should be required by central government to divest its commercial operations and contract out services. The Auckland Regional Services Trust is required by legislation to sell most of its assets, and compulsory competitive tendering has been applied widely in Australia and to roading in New Zealand. *The Economist* noted recently that compulsory tendering in Britain has made it easier for council leaders to push through difficult but desirable decisions in the face of opposition from staff and unions. To date, the Business

Roundtable has seen such issues as a matter for local decision, but the coalition agreement proposes restrictions on sales of certain council assets, and Stuart Macaskill has proposed even stricter restrictions – a 60 percent level of support in a poll of voters – on the sale of water companies. If, contrary to the trend of policy in recent years, Mr Macaskill is leading a move in local government towards seeking greater control by central government, perhaps this is an issue that ought to be debated openly at the national level.

Let me sum up. Local government has been a lagging sector in New Zealand's economic reform programme. It is pleasing that some councils are now quite vigorously changing the way they do things and may even be showing the way to central government.

Nevertheless, there is still a serious lack of focus and massive under-performance in the sector. Just in the last two months there have been media reports of the Auckland Regional Services Trust losing \$7.5 million on a recycling station, the Hutt City Council valuing a carparking building that cost \$22 million at \$6.3 million, and the Wellington City Council selling a works depot at a loss of \$11 million dollars, to pick just three random examples. Wellington deserves credit for exiting its works business, but it should never have been in it in the first place. Last year increases in charges for central and local government services consistently outstripped inflation in the private sector and made the Reserve Bank's job more difficult. Whereas central government reduced taxes and should be able to make further reductions in the near future, only a handful of local authorities have started to reduce their rates.

If New Zealand is to achieve sustainable non-inflationary growth at the levels targeted by the coalition partners, a much greater effort by local government will be required. At around \$27 billion in 1993/94 values, ratepayers' equity invested in local government is around half the market capitalisation of all the companies listed on the New Zealand Stock Exchange. Higher returns on these massive investments, whether they are retained in public ownership or shifted to the private sector, must clearly be part of any significant improvement in living standards.

The new financial management legislation is a welcome stimulus to better decision making in local government. In particular, it will throw a much clearer spotlight on the genuine public goods functions of councils, promote more efficient pricing and provide a better long-term perspective on trends in councils' spending, revenue, debt and net worth. It is disappointing that fewer than 15 percent of councils are ready to adopt the new framework this year. The business sector will be placing a good deal of weight on it in its submissions on forthcoming plans.

Finally, the government has signalled some initiatives in the coalition agreement which will affect local government. The document emphasises efficiency in local government and makes specific mention of the numbers of elected politicians, charging policies and levels, the separation of regulatory and service provision functions, competitive tendering and contracting out, and the Resource Management Act 1991. All these are relevant from a business sector perspective. Given the pressures facing farming and other export industries at present, the business sector will be looking for strong leadership from central government and within the local government sector this year to create an environment more conducive to business expansion and economic growth.

**REGULATION AND  
INFRASTRUCTURE**

**AIC 1997 NEW ZEALAND LAND TRANSPORT CONFERENCE**

**THE ROLE OF THE PRIVATE SECTOR  
IN ROAD INFRASTRUCTURE**

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

**WELLINGTON  
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# THE ROLE OF THE PRIVATE SECTOR IN ROAD INFRASTRUCTURE

## International Trends in Roading Provision

Although government provision dominates, private sector involvement in road networks is burgeoning around the world. It has several dimensions:

- road *construction* is commonly undertaken by private companies;
- private companies are increasingly developing *new technologies* for road operators;
- private sector *finance* is being increasingly sought for capital expenditures;
- *public roads* may be *operated* by private companies, commonly under leasing arrangements; and
- *private roads* may become part of the road network.

The growing private sector involvement in roads has many features which are common to developments in other network industries. One driving force which many governments face is the need for major additional capital expenditures.

In Europe, North America and Asia, economic growth and industrialisation have seen growing traffic volumes outstrip the capacity of the network. Anyone who has been to Bangkok in recent years will have observed this problem at first hand. Although typically less severe, congestion is also an issue in many of the world's major cities. A recent European Commission green paper reported that congestion is estimated to cost the European Union countries around 2 percent of gross domestic product (GDP) every year. In the United States it is reported that traffic volumes have grown 30 percent in the last decade, Americans lose 2 billion hours a year to gridlock, and congestion costs businesses US\$40 billion a year. The Federal Highway Administrator predicts that 34 percent more capacity needs to be built during the next decade just to stay even with the growth in vehicle miles. For 50 cities, that would cost US\$150 billion.

Further, many governments in the industrialised and former communist countries lack the will or the ability to raise the large amounts of finance necessary to upgrade their networks. Rather, they are struggling to reduce the size of the state sector, tax burdens and public debt, while facing great social pressures in the form of unemployment, welfare dependency and the needs of ageing populations. The collapse of communism and the success of a number of Asian countries in which government spending is less than 20 percent of GDP have served to undermine confidence in big government.

Finally, technological change is improving the efficiency of private billing systems. Previously toll booths required manual means of payment. These slowed traffic flows. New technologies are in the process of eliminating this problem.

As in the other network industries, private sector involvement in roading is likely to reduce unit costs substantially and improve the quality and mix of services. The scope for such gains depends on the extent of privatisation and on the quality of the constraints which are imposed on providers of road infrastructure.

Growing private sector involvement is associated with increasing recourse to the use of tolls. In 1993 the Reason Foundation published a list of countries in which private tollway road projects were under study, under construction, being franchised, or operational. The list encompassed 33 countries and scores of projects. The greatest levels of activity were in Australia, Asia and Western Europe.

Australian developments included the Sydney Harbour Tunnel, Sydney's F4 and F5 tollways and (more recently) the Melbourne airport tollway. Activity in Asia included the major Hong Kong-Guangzhou superhighway, the Guangzhou ring road, Malaysia's North-South Toll Road, Thailand's second stage expressway and the Bangkok elevated transport system. Other private tollways were under construction in Italy, France and Mexico.

In the United States, greater private sector involvement has followed permissive changes in legislation at the federal and state levels. In 1991 Congress decided to allow new tolls on federal roads and joint private and public funding of new investment. Some states have been more permissive, passing experimental laws designed to allow 100 percent private funding. I would note that joint private/public sector funding creates risks for the government concerned in respect of the privately owned party's performance. It may also create the perception that the government is implicitly underwriting its partner in the joint venture. Unless these risks are clearly negligible, 100 percent private sector funding seems more desirable from a public policy perspective.

Reflecting the easing of the earlier constraint on private sector involvement, a US\$326 million, 22.5 km private road has since been built in Virginia, linking Dulles airport to Leesburg. This is the first private toll road to be built in the United States in more than a century. It is reported to be unprofitable and in the process of rescheduling its debts. The second, a 16 km strip of four commuter lanes (known as SR-91), is in suburban Los Angeles. It is the world's first non-stop toll road and is reported to be profitable. Other private roads are planned in Arizona and Oregon.

The United Kingdom is also represented with the completed Dartford crossing toll road, the awarding of franchises for two bridge routes, and the Birmingham Northern Relief Road.

Israel is planning a 300 km multi-lane highway which will involve private investment and the use of transponders for billing purposes.

### **Relevant Developments in New Zealand**

In New Zealand, the prime minister announced his support in 1996 for private sector construction of toll roads – as long as motorists had the choice of a free route. Malaysia has actually implemented this philosophy but is debating removing the restriction where the new road is necessary to improve safety.

Also in New Zealand, Infratil has a heads of agreement with the Rodney District Council to fund, build and franchise a road across the Weiti river in the Whangaparoa peninsular, north of Auckland. Currently the proposal is the subject of an environmental impact study. If the road goes ahead, it will be the first privately owned toll road (other than special purpose roads) built in New Zealand in recent times.

New Zealand is well on the way to making the provision of road design, supervision and construction contestable. In respect of state highways, all this work has been bid for in open competition since 1 July 1991. Robin Dunlop, general manager of Transit

New Zealand, reported recently that the savings for 1991–95 from these measures averaged:

- 30 percent in professional services; and
- 17 percent in maintenance.<sup>1</sup>

The combined savings in maintenance and management of state highways amounted to approximately \$135 million during the five years.

Some local authorities have recognised the benefits of greater private sector involvement more quickly than others. The tardy ones tend to be victims of the usual problems of conflicts of interest, anti-private sector ideologies and ineffective leadership. Conflicts of interest arise where a purchaser of services is also a provider or a regulator. Ineffectual leadership means public debate is limited to matters of rhetoric, emotion and self-serving defence of cross-subsidies and does not address the core matters of service quality, reliability and unit cost.

Generally speaking, the larger local authorities have been the least innovative, and their decisions have the greatest impact on the national economy. As in the cases of Papakura with water and Rodney with roads, it is the smaller local authorities which are leading the way. The Wellington Regional Council (WRC) and the Auckland Regional Services Trust (ARST), for example, stand out for their resistance, if not outright opposition, to divestment. What can explain the fact that the ARST still owns a bus company many years after the Wellington City Council privatised its bus service, with major benefits to local commuters?

As the World Bank has cogently argued, ownership matters. Incentives to manage resources efficiently are stronger under private ownership. The leading opponent of privatisation in local government is Stuart Macaskill, chairman of the WRC. His stated reasons for opposition in the case of water are becoming increasingly eccentric, the latest being that it would lead to riots in the streets. Strangely, we do not seem to hear of water riots in Papakura, Waiheke Island, Oamaru and the many cities in Britain, France, Australia and the United States that depend on private supplies or plan to do so. The WRC's opposition to the Wellington City Council's decision to put its contract for the maintenance of its water supply system out to competitive tender simply highlights the potential for conflicts between the WRC's interests as a provider and the interests of end users.

### **Problems with Government Control of Roothing**

With the road network currently being subject to central and local government decision making, two concerns arise. The first is that new investment may not be forthcoming in a timely manner where it is most needed. The second is that the existing infrastructure is not being operated as efficiently as possible. In both cases there appears to be a need for greater urgency in reducing barriers to more commercial approaches, including greater private sector involvement.

Clearly the issue which is most worrying users of Auckland's roads is the growth in peak period congestion. The Auckland Regional Council's (ARC) land transport strategy document (September 1995) observes that traffic flows on the arterial road network have increased by 2 percent per annum at peak periods for the last ten years, and the capacity of the system has not kept pace. It comments that population growth is around 34,000 people per annum – equivalent to the population of Dunedin arriving in each future four-year period – and much higher than the 15,000 per annum previously expected. As a result it reports that:

<sup>1</sup> Robin Dunlop, 'The Future Organisation and Management of the Roothing System', *Road & Transport Research*, Vol 5, No 4, December 1996, pp. 54–63.

Serious congestion is now being experienced in the major travel corridors in peak periods, and delays are increasing at many locations throughout the region.

In any network industry, one would expect a major upsurge in demand with pressure on peak capacity to give rise to urgent plans to bring in extra capacity and to raise prices for peak-time usage, where it is feasible to do so. However, it is disturbing to discover in the same document that there appears to be a different philosophy on the first issue and no sense of urgency about the second. For example, the document states that while there are many benefits to personal mobility, a new approach is now needed:

A different approach is required from simply building more roads to meet the ever-increasing demands for vehicle travel.

The general theme appears to be that consumer preferences for personal convenience and mobility should be ignored in favour of shared transport and higher population density living. However, as the communist nations found, human nature cannot easily be changed. Nor is it clear why the ARC believes that its proposals for achieving these changes will be effective. The less confident we feel about measures like light rail, parking charges and subsidies for off-peak bus travel, the more urgently we should look for direct billing systems and enhancements to capacity. Getting prices right across the Auckland transport system and maximising the incentives for investment and entrepreneurship on the part of all transport providers, including roading operators, is surely the key to the solution of Auckland's problems.

### **Directions for Reform**

The general problem with current regional land transport strategies, at least in Auckland and Wellington, appears to be that local authorities have not clearly separated the overriding objective of providing an efficient road transport system from other objectives such as the regulation of safety and pollution. Nor are the issues of purchasing (or subsidising) services for pedestrians and others who may not pay the provider directly, or who may be deemed to justify subsidised transport, addressed separately from provider issues.

It is true that local authorities are constrained by legislation which complicates decision making or restricts their options. The very high cut-off benefit/cost ratios for capital works on roads are also worrisome in this regard. But the difficulties are compounded by the failure to treat separate issues separately. This creates the all-too-common political problem of determining how to balance conflicting objectives and interests. The interests of environmentalists, pedestrians, cyclists and bus commuters do not necessarily coincide with those of other road users.

Separating the provider's objectives (using a state-owned enterprise (SOE) or a Local Authority Trading Enterprise (LATE) structure) from those of a regulator, purchaser or subsidiser would, I suggest, lead to much greater clarity and accountability for performance in respect of each role – and it would lead to different statements of objectives. For example, who would dream that Telecom would set a goal for a target decrease of no more than 10 percent in the quality of its service between 1991 and 2011 because of the growth in demand? But the ARC's 1995 land transport strategy document proposed just such a reduction in the quality of service (as measured by average travelling times) to be delivered to non-passenger motorists between 1991 and 2011. Even more egregiously, the WRC has adopted a bizarre anti-motorist policy which states that the capacity of the road system should never be expanded to cater for peak demand. Recently the WRC's deputy chairman indicated that he favours abandoning the policy, and it must be hoped that sanity prevails.

In respect of roads, users should be expecting the providers of road services to develop much more efficient billing and charging systems. Rather than trying to change user preferences in the face of current prices, providers should be aiming to satisfy these preferences at least cost. Far from trying to restrict growth in demand where there is a willingness to pay, providers should be keen to cater for that demand.

The use of rates for funding a road network operated on more commercial lines should diminish. Such a source of revenue is not relevant for other network industries, the state highways, the extensive private roads which exist in New Zealand to serve forestry and agriculture, and the construction of roads for new subdivisions. Councils might use ratepayers' money to subsidise certain groups or to purchase bus or other transport services, but the network provider would just treat any payments it received as another form of revenue. As an interim arrangement, funding could be by way of shadow tolling or other forms of contracting. Any of these options are likely to increase the pressures on central and local government to sort out the proper distribution of the money currently being raised from road users.

If New Zealand moves more urgently in the directions I have been discussing – institutional reform, the adoption of more direct billing technologies and greater private sector involvement – further substantial efficiency gains can be expected. They would arise from two sources:

- demand management; and
- better focused maintenance and capital expenditure decisions.

Achieving further gains in these areas is the challenge for roading operators in the next decade. In my view, the broad direction for further reform is clear. Earlier transport sector reforms separated the functions of policy advice, regulation and provision among central government agencies. Road funding has now been separated from provision with the creation from 1 July 1996 of Transfund New Zealand. New Zealand is so far the only country to have established a separated dedicated funder of roads with an independent board, although Kenya has developed a dedicated fund for maintenance expenditure and others are considering the idea. This separation should result in much greater clarity about what services the road infrastructure is required to deliver.

In terms of organisational reform, the next challenge for New Zealand is to convert the providers of state highways and local roads into SOEs or LATES. Such structures will improve incentives, accountability and clarity about what is expected from providers of the network.

Closely related to institutional evolution is the issue of road pricing. Road pricing has long been bedevilled by the inefficiencies of direct billing system technologies available until recent times, and the usual mix of problems which face government providers – multiple and conflicting objectives, weak incentives, divided interests, *ad hoc* political interference and lack of quality information about users' willingness to pay.

If charges for road users could more closely reflect the quality of the infrastructural services being provided at the location and time of use, providers would be in a much better position to ascertain what value users put on improvements in surface quality, safety and capacity, and user demands would better balance benefits and costs.

### **Developments in Road Pricing**

Reflecting a general awareness of such factors, interest in congestion pricing has continued to grow. Several large firms have entered the field of electronic toll collection. Technological change has now brought efficient billing systems into the

planning time horizon which is relevant to the institutional reforms just mentioned. Transit New Zealand has stated that "reliable direct revenue collection should be available within 5-10 years". Other countries are already well ahead of New Zealand in implementing such technologies.

For example, all three of Norway's largest cities, Oslo, Bergen and Trondheim, use electronic tolling and were reported by the Reason Foundation to be considering implementing peak/off-peak pricing. Singapore started its electronic toll road (area district licensing) system in 1994. It first introduced peak-time pricing in June 1995 on the East Coast Parkway. It is extending the scheme for morning peak-hour travel to the Central and Pan-Island Expressways from May 1997.

According to newspaper reports, a Swedish-based company has just been awarded a A\$40 million contract to supply electronic tolling equipment for Melbourne's A\$1.8 billion City Link tollway project. The contract involves the supply of transponders for over 600,000 vehicles and associated roadside equipment. This is equivalent to supplying transponders for about one third of New Zealand's registered motorised vehicles at an average capital cost of about NZ\$75 per vehicle. Cars will be automatically billed for the use of the tollway without having to stop. The southern link component of the new tollway is expected to be completed by December 1999.

In the United Kingdom, two types of electronic system are being trialled on a special test track. Commentators envisage cars paying 1.5p a mile and lorries 4.5p a mile. The European Union has an ongoing research programme on electronic tolling. Many cities (including London, Stockholm, Amsterdam and Rotterdam) have initiated, or are in the process of initiating, detailed studies of road pricing.

In the United States, the world's first non-stop toll road has been constructed in the SR-91 Express Lane project located outside Los Angeles. This road is 10 miles long and four lanes wide. Vehicles with fewer than three passengers have to pay a toll. This road is reported to be making money for the operator. Automatic tolling is being tested on the Interstate 80 Carquinez Bridge. In New Jersey, the state assembly recently passed a bill authorising the state's three highway authorities to install a tolling system in which bar codes on cars would be read by lasers. An eight-year contract valued at about US\$500 million has been awarded.

In Hong Kong, the first 'red-chip' tollroad company was listed on the local stock exchange in January 1997. It has six road projects in the Guandong area. Australia also has a publicly-listed road infrastructure project - the Hills Motorway Trust which is funding the construction of the M2 Motorway on Sydney's North Shore. In Malaysia, some roads are being privatised for road safety reasons.

Transponder-based systems may be used for other purposes, such as the provision of traffic information to passing motorists, automated 'smart pump' fueling systems and the detection of traffic offences.

Better information about user willingness to pay, and the strengthened incentives with more commercial arrangements to relate benefits to costs, should result in improved maintenance and capital expenditure decisions by road operators.

In the absence of commercial billing technologies, revenues would have to continue to be derived from less flexible tax- or levy-based systems. Typically these systems do not allow time-of-day or route-specific charges. While shadow tolls could be used as a source of revenue related to traffic volumes for a privately or publicly owned provider, traffic volumes are an imperfect proxy for the services which are being provided.

Shadow tolling could facilitate private sector participation in operating roads through franchise arrangements and related structures. These include the many variants of private involvement in building, developing and operating roads.

The Land Transport Pricing Study discussion papers released last year commented favourably on the possibility of direct charges for peak-time use of the Auckland Harbour Bridge and of State Highway 2 from the Hutt Valley to Wellington. In general, however, these papers only represented a very limited step towards the adoption of more efficient pricing arrangements, which is disappointing. In my view the government should give consideration to making Transit New Zealand (and local authority providers as appropriate) responsible for proposing more efficient pricing arrangements. This is the task of the provider in other network industries, and arguably we should be moving in the same direction in respect of roads.

### Options for Private Provision

There are many ways in which local authorities could involve the private sector more intensively in the provision of road network services. One option would be to simply call for tenders from private firms to build, enhance or maintain some component of a network to a defined level of service. There are many possibilities for the design of such contracts. For example, they might be awarded on the basis of the least cost bid or on the basis of traffic count.

Franchise arrangements combine public sector ownership and regulation with private sector provision. There are a number of risks here. One is that the relationship between the regulator and the provider will become unduly cosy. Economists call this regulatory capture. Performance can be expected to fall if tenure is likely to be assured. An opposite risk is that the incumbent will allow the asset to run down towards the end of the lease – because of the risk that the benefit from further investments will accrue to a competing bidder. A third risk is that the detailed regulation which is implicit in the franchise contract will inhibit flexibility and innovation. The public authority's lack of good information about user willingness to pay and its own mixed incentive structures create these difficulties.

For such reasons consideration must also be given to the long-term goal of full privatisation of road networks, subject to as light-handed a regulatory environment as can be achieved. This option is by no means beyond contemplation.

For example, the British government has been considering privatising the country's road system. In 1996, the Transport Secretary, Sir George Young, was reported to have drawn up plans for seven regional corporations which would take over the roads in return for petrol taxes and car registration fees.<sup>2</sup>

Moreover, the British Roads Federation recently published a report 'Modern Roads – Making the Change', which proposed that roads could be run as a regulated utility service like rail, water, gas, electricity and telecommunications. The utility would be required to meet set service standards. According to a newspaper report, Neil Ashley, chairman of Amey, stated that:

The current network will move, in its entirety, into the private sector in the next 25 years ... [and],

The current upsurge in market testing and privatisation of a growing number of functions is, effectively, the process of moving the network into the private sector where the user will pay.

<sup>2</sup> *New Zealand Herald*, 4 March 1996.

## Conclusion

In conclusion, I have no doubt that, as in other countries, private sector involvement in the provision of road infrastructure in New Zealand will continue to grow. I also have no doubt that greater private sector involvement, institutional reform of public sector provision and more efficient billing technologies have great potential to raise efficiency in this important area of economic activity.

The greatest concern that I and others in the business community would have is that this is yet another area in which New Zealand is moving too late and too slowly. I am aware that the legislative and other barriers in the way of reform are very real. But it is surely fair to ask why central government and councils are taking so long to address these issues. In the meantime, it is hard not to feel anything but disquiet about the response of the roading authorities in Auckland and Wellington to the problems of growing congestion. Experience overseas shows that congestion can become extremely severe if capacity does not adjust to meet demand. With an economy that is achieving higher average growth than in the past and which could do much better yet given continuing reforms, the economic costs of poor roading policies could be very high.



**SUBMISSION BY THE  
NEW ZEALAND BUSINESS ROUNDTABLE**

**PRODUCER BOARD ACTS REFORM BILL**

**APRIL 1997**

# PRODUCER BOARD ACTS REFORM BILL

## 1 SUMMARY

1.1. To secure a viable future, the industries covered by the Producer Board Acts Reform Bill (the Bill) must match the rates of improvements in innovation and productivity of other sectors in a better performing economy. Otherwise, they will lack profitability and be unable to compete successfully for resources.<sup>1</sup> The sectors must therefore be freed from all unnecessary handicaps and distractions.

1.2. In recent years there has been a growing shift in thinking about appropriate institutional and regulatory arrangements for the primary sectors, and a wider recognition of the extent to which the pervasive role and powers of the producer boards have cast a shadow over the meat and wool sectors. The sea-change in perceptions about the role of the boards in competitive and open markets has overtaken the outcome of the 1994 review of institutional arrangements in the meat and wool sectors undertaken by Federated Farmers and the introduction of the Producer Board Acts Reform Bill. There is now a great deal of questioning, including by people who are close to them, about whether the boards are needed at all.

1.3. The factors that make the industries covered by the Bill in any sense special are minimal. The very limited grounds for government intervention that exist do not warrant retention of the full paraphernalia of the boards. Moreover, their retention would guarantee a continuation of the byzantine manoeuvrings, pressures and industry politics which characterise this industry like few others, and which divert commercial effort unnecessarily.

1.4. The submission of the New Zealand Business Roundtable (NZBR) is that the Primary Production Committee should recommend either:

- that the boards be wound up with their assets sold and distributed to levy payers;  
or
- that the boards be reconstituted as companies with shares allocated to producers (for example, on the basis of previous levy payments).

1.5. If producers wish to continue to fund promotion or research through a compulsory levy, they could use the provisions of the Commodity Levies Act 1990, modified as necessary to address its weaknesses.

## 2 OVERVIEW

2.1. This submission is made on behalf of 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.

2.2. The NZBR has taken a close interest in the subject of agricultural marketing regulation. The system of regulation that governs the export of the major agricultural products and underpins the operation of the producer boards affects, directly or indirectly, nearly half of New Zealand's export trade. It therefore has a major impact

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<sup>1</sup> The Meat Board, for example, has presided over an industry that has seen a trend decline in real beef and sheepmeat prices since the early 1970s, while the board has enjoyed an upward trend in levy income.

on the performance of the whole economy. Unlike most other areas of government regulation, this set of interventions has merely been tampered with in the last 10 years.

2.3. Because of the economic importance of the topic and the lack of attention given to it by successive governments, the NZBR undertook a major independent evaluation of the present forms of intervention, including those in the meat and wool sectors. This was published in October 1992 under the title *Agricultural Marketing Regulation: Reality Versus Doctrine*. The study concluded that the poor performance of the meat industry over the previous decade reflected the fact that it was a victim of politics and vested interests which dominated industry developments at the expense of commercial incentives and marketplace outcomes. Likewise, it found that the pervasive influence of the Wool Board overhung the entire marketing system for wool like a giant shade tree, leaving the commercial participants stunted and fragmented.

2.4. The Producer Board Acts Reform Bill (the Bill) is a partial recognition of the problems which have plagued the primary sector. The Bill provides for:

- the functions of the meat, wool and pork industry boards to be redefined to:
  - increase demand for industry products,
  - conduct or fund research and development,
  - encourage the adoption of more efficient processes and practices in the boards' respective industries,
  - collect, process, maintain and make available information to help production, investment, processing, product development and marketing decisions;
- a function of the Meat Board to facilitate exports to markets where there are imposed restrictions or requirements that directly affect access of New Zealand meat;
- powers to be granted to the Meat Board to license exporters, impose requirements on exports in certain circumstances (including allocation of access to tariff quota markets), set quality standards for export meat and maintain a carcass description system. The previously restrictive export licensing regime is to be changed to a permissive regime of 'on demand' licensing;
- new accountability arrangements for the boards; and
- in the case of the Meat Board, for the inclusion of processors' and exporters' representatives on the board of directors.

### 3 WHAT PROBLEMS DOES THE BILL ADDRESS?

3.1. The general policy statement which accompanies the Bill gives an indication of its background and purposes:

- the boards are intended to adopt a role of facilitation rather than intervention and direction, thus opening up the opportunity for more cooperative action with other industry participants. The general policy statement asserts that "interventions with the potential for limiting growth are being removed" (page iii); and
- a goal of greater accountability of the boards to producers. The objects of the boards are intended to strike a balance between the boards' accountability to their levy payers, their responsibility to the wider industry, and the national interest.

3.2. The NZBR endorses the observation in the general policy statement that, given the size of the sectors subject to the legislation, it is crucial that the regulatory

environment is conducive to the development of competitive and innovative industries.<sup>2</sup> The Bill is a recognition that the previous (and potential future) use of existing statutory controls in the primary sector has left it poorly placed to compete for resources against other less encumbered and more dynamic sectors of the economy. The meat and wool sectors have been squeezed by a combination of a rising exchange rate, higher wages and higher prices for land and other assets. These are all signs of economic success, but they make life difficult for lagging industries.

3.3. No industries in New Zealand have suffered more than meat and wool as a result of years of government and producer board meddling. Uncertainty about the use to which regulatory powers might be put has discouraged investment, including foreign investment, in the industry. In the case of both meat and wool, this has led to industry fragmentation and a weak commitment to long-term marketing strategies.

3.4. It is not just direct intervention in the meat and wool sectors that has harmed their performance. Spillover effects from inappropriate regulatory arrangements in other sectors, notably the dairy sector, have also severely affected the profitability of meat and wool farmers and caused a misallocation of resources that affects the economy at large. This has been manifested in the conversions of farms to dairying. If conversions reflected a response to genuine underlying trends in the economy they would not be a cause for concern. But the large distortions that exist in the dairy industry as a result of the bundling of on-farm and off-farm returns mean that the changes in land use are being driven to a significant extent by artificial factors rather than the realities of international market demand. Over-production of milk and under-production of products which require similar resources are now clearly apparent, as are the difficulties faced by the Dairy Board in coping with the growth rate in milk production. A study commissioned by the NZBR estimated the costs to the New Zealand economy from the pricing distortions alone in the dairy industry to be \$145 million annually.<sup>3</sup> The dynamic losses in economic efficiency arising from the Dairy Board's monopoly on export sales could easily be larger.

3.5. The history of interventions in the primary sector and their wider effects suggest the following imperatives in considering the Bill:

- the wider community has a valid interest in regulatory arrangements that apply to a particular sector.<sup>4</sup> It is sometimes argued that producers in the meat, wool or dairy sectors should have the primary input in what regulatory arrangements should apply to their sectors. However, this view ignores the costs imposed on the wider community from those arrangements, for example, the effects of the dairy industry structures referred to in the previous paragraph. Little progress on tariff reform would have been made since the mid-1980s, for example, if views that reflected the interests of protected manufacturers had determined the outcome; and
- there needs to be a more thorough scrutiny of the grounds for statutory intervention based on a contemporary approach to public policy analysis than has occurred in the past. Earlier mistakes, or pointless tampering with existing statutory controls (like previous changes to accountability arrangements in the

<sup>2</sup> Page iii.

<sup>3</sup> Tasman Asia Pacific and ACIL (1996), 'The Economy-wide Effects of Bundling Milk and Non-Milk Returns', Wellington, New Zealand Business Roundtable.

<sup>4</sup> Wider community interests are reflected, to some extent, in the objects of the boards (for example clause 6), where the Meat Board must have regard to the desirability of the meat industry "...making the best possible net ongoing contribution to the New Zealand economy". However, general statements such as these are notoriously difficult to interpret and beg the question of whether it is (or should be) within the Board's power to affect the contribution of the meat industry to the national economy.

meat and wool sectors), would have been avoided if these criteria had been applied.<sup>5</sup>

3.6. The Bill therefore provides a unique opportunity to address current statutory impediments to the profitable development of the meat, wool and pork industries in the light of sound public policy criteria.

#### 4 GROUNDS FOR STATUTORY INTERVENTION

4.1. Market transactions predominate in our economy and those of most of the developed world. No one enters into voluntary transactions without expecting to benefit. Accordingly, market transactions provide a means of coordination among a myriad of producers, intermediaries and consumers. The interdependence of marketers and producers has been described as follows by one commentator:

From an international point of view, historical development implies that the control of the system will rest with the marketers and processors with contracts being formed with the producers in order to achieve the required level and quality of supply. This does not imply that the producers are necessarily disadvantaged in such a system as the business of the processors and marketers depends upon the product supplied by the producers and the quality and reliability of that supply. The whole system becomes interdependent and must be seen in this way, rather than as a confrontational process.<sup>6</sup>

4.2. The interdependence and coordination of willing buyers and sellers in most markets is something that occurs without compulsion. The question is whether coordination that occurs through producers, processors and marketers acting without compulsion is insufficient on public policy grounds and must be supplemented by statutory interventions of the type contained in the Bill. In other words, is there any valid reason why these industries should be subject to different rules from those which now govern commerce in almost all other sectors of the economy, including much of the primary sector?

4.3. Equity issues aside, there are widely accepted public policy grounds for evaluating existing or proposed interventions by governments in the interests of promoting community welfare. The central role of the government in relation to the production, sale and distribution of agricultural products, including meat, wool and pork products, is to establish a regulatory framework which encourages individuals and firms to take decisions that will make the best use of scarce economic resources. The government's role in this regard is no different than for any other economic activity. Possible grounds for statutory intervention include:

- reducing the costs of individuals and firms transacting with each other;
- funding the provision of public goods which will be inadequately provided by the market;
- ensuring that firms earn sufficient rewards from goods and services that yield wider community benefits (referred to as externalities) to ensure that they are adequately supplied;<sup>7</sup>

<sup>5</sup> An example is tampering with legislation to give effect to the outcome of a previous review undertaken by the Weir Committee, of accountability arrangements for the Meat and Wool Boards.

<sup>6</sup> Sheppard, R (1993), 'Agricultural Restructuring Effects: an Industry Perspective', Paper presented to the New Zealand Agricultural Economics Society Conference, 1-2 July.

<sup>7</sup> Conversely, fees or taxes might be justified if firms do not face all the costs they generate.

- promoting competition; and
- promoting the provision of goods and services which are likely to be under-supplied because of difficulties in obtaining information.

4.4. With the support of appropriate legislation to address the issues noted above, markets involving transactions by willing buyers and sellers are best able to allocate resources to their most productive uses. The onus should be on those who argue for special rules for the meat and wool sectors to establish a positive case for any interventions, based on sound analysis.<sup>8</sup> In particular, it is necessary to show that:

- one of the grounds for intervention listed above applies to the production and exporting of meat and wool;
- if those grounds do not apply, there are unique aspects of meat and wool products that distinguish them from other products and justify statutory interventions;
- any intervention produces benefits that are greater than any costs; and
- the statutory interventions set out in the Bill are the most appropriate.

4.5. In the remainder of this submission, the foregoing criteria are applied to assess whether a positive case can be made for the statutory interventions and powers set out in the Bill.

## 5 RESEARCH AND PROMOTION

5.1. In clauses 7, 90 and 132, the Bill provides that functions of the producer boards include increasing the demand for their respective products (including, presumably, through marketing and promotion) and undertaking research. Expenditures on research and promotion are the most commonly cited examples in the agricultural sector of services which have some of the elements of a 'public good'. Public goods or services exhibit both of the following features:

- it is difficult to exclude non-payers from the enjoyment of the benefits of the goods or services; and
- the extra cost (and therefore the price) of providing such goods or services to an additional user is very low or zero. In a narrow sense, the cost of providing street lighting for the extra passer-by would be zero. The extra cost of providing wool promotion to one more grower would likewise be close to zero.

5.2. Pure public goods are rare, if not non-existent, although many goods exhibit some of their features, such as some aspects of research and development (for example, because of the difficulty of excluding non-payers from the enjoyment of services funded by payers). If left to the private market, arguably not enough of these goods would be supplied.

5.3. Against this, however:

- mechanisms exist to exclude non-payers from the benefits of promotional expenditure where it is economic for funders of promotion to use them. Examples include the development of brands and trade or quality marks. These represent

<sup>8</sup> This is in contrast, for example, to a starting presumption that all commerce should be fully regulated and goods and services should be provided by the state.

property rights which are given statutory protection through trademarks and patents. Rules protecting brands or trademarks enable the person who invests in promotion or quality improvement linked to a brand or quality standard to capture most (if not all) of the benefits of that expenditure. Non-payers do not derive any direct benefit since they are denied use of the brand or quality mark. The implications of the development of stronger patent, licensing and copyright arrangements which have made it easier for companies to capture and protect the benefits of research were noted by the Industry Commission in Australia. The Commission concluded that stronger property rights were a contributing factor to a new climate that provided greater opportunities for research by individual companies;<sup>9</sup>

- interventions could prevent the development of alternative mechanisms which may be more effective in the longer term. The imposition of levies to fund generic promotion or research, for example, may displace research or promotion that would otherwise be undertaken directly by stakeholders. Since processors and other intermediaries face stronger incentives and have better information than producer boards to optimally tailor promotion to market needs (including incentives to decide whether to fund promotion at all), producer-funded generic promotion is likely to be a poor driver of success; and
- even if non-payers cannot be excluded, it may still be worthwhile for stakeholders to invest in promotion and research since the pay-off may be high enough to make it worthwhile.

5.4. It might also be argued that expenditure on research gives rise to externalities which are not captured by the funder of the research. Supposed externalities are widespread and do not necessarily imply the need for intervention. As observed by Nobel laureate Ronald Coase:

The ubiquitous nature of 'externalities' suggests to me that there is a prima facie case against intervention, and the studies on the effects of regulation that have been made in recent years in the United States, ranging from agriculture to zoning, which indicate that regulation has commonly made matters worse, lend support to this view.<sup>10</sup>

5.5. Even in markets where externalities might exist, such as the provision of computer communications networks, competing firms often cooperate by standardising technologies or protocols without government intervention. Externalities might also be ignored by consumers and producers because of inadequately defined property rights (such as patent rights). In these cases, better defined property rights are likely to be a preferable alternative to centrally determined subsidies or taxes.<sup>11</sup>

5.6. As well as increasing costs incurred by producers, arrangements to fund favoured research and promotion projects through compulsory levies increase the risks producers face. The levies that fund the Meat and Wool Boards represent a significant proportion of the before-tax net income of producers. The average sheep

<sup>9</sup> Industry Commission (1994), *Meat Processing*, Report No 38, Australian Government Publishing Service, Melbourne.

<sup>10</sup> Coase, R H (1988), *The Firm, The Market and the Law*, Chicago, The University of Chicago Press.

<sup>11</sup> It is notable that property rights in respect of board-funded activities are often quite weak. For example, calls are being made to franchise the 'Fernmark'. There may also be some doubt about the strength of property rights in respect of the Meat Board's carcass grading system.

and beef farm is likely to pay a levy of around \$2,200 to fund the Wool Board in 1997.<sup>12</sup> Additional levies to fund the Meat Board are around \$1,100.<sup>13</sup> Total levies of around \$3,300 represent approximately 12 percent of forecast 1997 net profits before tax (this amount excludes the forgone returns to producers on reserves held by the boards).

5.7. The bulk of levy receipts is used to fund promotion and research by the boards. It is doubtful whether many producers would voluntarily choose to fund these activities to the extent of 12 percent of their net income compared to using the resources for other purposes. The benefits (and costs) of levies paid by producers are, in reality, shared with consumers and the processors of the commodity. The producer's share is determined by the relative responsiveness (elasticity) of supply and demand for the commodity to changes in prices.

5.8. This raises the likelihood that the benefits producers derive from promotion and research into off-farm processes are less than their share of costs. It is unusual for producers of raw materials to finance the promotional budgets of processors and marketers. Depending on the price responsiveness of products, all or a proportion of levies paid by producers represent a wealth transfer to intermediaries and final consumers.

5.9. A recent study on the impacts of brand and generic advertising on meat demand in the United States concluded that, relative to increases in advertising expenditures, considerably smaller percentage reductions in beef prices are necessary to induce equivalent increases in consumption.<sup>14</sup> This implies that funding of promotion may provide much lower yields to producers than expenditure (including research) aimed at reducing on-farm production costs. Another commentator has argued that "...producers should prefer a research-induced decrease in production costs to an equivalent promotion-induced increase in retail price and to a decrease in marketing costs".<sup>15</sup>

5.10. There is a difference between advertising that is observed to be successful because it induces increased demand, and profitable advertising. For example, an expansion in domestic demand may merely divert product from the export to the domestic market. If export and domestic prices are similar, then average prices (and hence revenue to producers) do not increase. Pre-advertising profits are reduced by the amount of the advertising expenditure.<sup>16</sup>

5.11. If nothing else, this potential implication shows the naïveté of the thinking behind the proposed function of the producer boards to increase demand for their industries' products. Even if this could be achieved by a continuation of the traditional emphasis on promotion, which is improbable, the pursuit of such a goal may reduce producers' net income.

5.12. Commercial judgments about the allocation of resources among promotion, research and other activities are made by businesses every day. However, compulsory levies paid to fund a variety of research, promotion and other board

<sup>12</sup> Five percent of forecast wool revenue of \$43,100 from an average all classes sheep and beef farm (MAF, 1996, *Situation and Outlook for New Zealand Agriculture*, Wellington, p. 54).

<sup>13</sup> *Rural News*, 10 March 1997.

<sup>14</sup> Brester, Gary and Schroeder, Ted (1995), 'The Impacts of Brand and Generic Advertising on Meat Demand', *American Journal of Agricultural Economics*, 77, p. 969-979.

<sup>15</sup> Wohlgenant, M K (1993), 'Distribution of Gains from Research and Promotion in Multi-Stage Production Systems: The Case of the US Beef and Pork Industries', *American Journal of Agricultural Economics*, 75, p. 642-51.

<sup>16</sup> This issue is noted in Piggott, R R, Piggott, N E and Wright, V E (1995), 'Approximating Farm-level Returns to Incremental Advertising Expenditure: Methods and an Application to the Australian Meat Industry', *American Journal of Agricultural Economics*, 77, p. 497-511.



activities are a cumbersome mechanism to address the trade-offs involved. Accountability arrangements provide little protection against the risk that, as in the past, the resources of producers will be devoted to a narrow range of risky schemes. Resources may be over-committed to currently fashionable marketing or other strategies which, with the passage of time, prove to be ineffective.

5.13. The dynamics of continuously changing markets mean that no one person or organisation can know for sure whether resources are best spent on on-farm or off-farm development, whether research which reduces on-farm costs should be favoured over promotion, or whether generic or branded promotion provides superior returns. In other sectors, diverse and competing approaches by producers, processors and other market participants making their own investment choices allow successful strategies to emerge over time. However, these opportunities are thwarted in the industries covered by the Bill since the legislation continues to place decision making on the use of substantial producer-financed resources in the hands of a few.

5.14. The grounds for intervention to fund research and promotion that differ from those of most other industries are weak, and any benefits are unlikely to exceed associated costs. Promotion and research should be the responsibility of those who directly benefit and who are best placed to make the trade-offs involved. At most, producers should have access to the mechanics of the Commodity Levies Act 1990 (modified if necessary) if sufficient numbers decide to collectively fund promotion and research.

## 6 MANDATORY GRADING AND QUALITY STANDARDS

6.1. In Part VII the Bill provides for the Meat Board's current grading powers to be replaced by the power to establish carcass description systems, with the point of compulsion shifting from the point of export to the meat processing plant. Under Part VI the Board will have powers to set quality standards for export meat quality that do not relate to hygiene or importing countries' sanitary requirements (which are the province of the Ministry of Agriculture). Part IV provides for the board to impose export requirements in response to restrictions imposed by authorities in export markets.

6.2. It is sometimes argued that statutory intervention along the lines embodied in the Bill is necessary because product characteristics are frequently difficult for consumers to observe due to high information costs. Consumers may, for example, be unsure about the properties of meat byproducts, or the quality of wool offered for sale. If consumers are less informed than suppliers about product quality, bad suppliers can end up driving out good ones.<sup>17</sup>

6.3. However, situations where consumers know less than suppliers about the quality and other characteristics of a product are not uncommon. In these situations consumers are prepared to pay for a good product if they have assurance about its quality. Suppliers can respond by certifying the quality of a product and thereby enhance their returns. The supplier's incentive to report accurately the quality of the goods offered arises from the returns of building a good reputation. These returns can be greater for intermediaries (such as meat processing companies or wool brokers) since they carry out more transactions than individual suppliers.<sup>18</sup> Accordingly, an intermediary can offer many different products (of differing dimensions and qualities) for sale, and consumers can rely on the reputation of the intermediary without the

<sup>17</sup> This is often referred to as the 'market for lemons' problem.

<sup>18</sup> Spulber, Daniel (1996), 'Market Microstructure and Intermediation', *Journal of Economic Perspectives*, 10(3), p. 135-152.

need to investigate the many product suppliers. In particular, the intermediaries can serve as guarantors of product quality through warranties and contract terms.

6.4. Mandatory grading systems and quality standards cut across these normal market responses. Provided valid hygiene and sanitary concerns are addressed in accordance with international obligations, any other mandatory quality standards are an attempt to impose a particular market differentiation strategy. Judgments about the viability and nature of such strategies should be left to market participants, who have the strongest incentives and best information to get them right. Removal of mandatory requirements would mean that:

- certification costs would be targeted more effectively on products for which the demand is most responsive to the setting of standard grades or quality marks;
- each marketer would have an incentive to ensure that the grades or quality standards met the needs of importers and consumers while enhancing the marketer's reputation; and
- incentives faced by producers and processors would more fully correspond with those dictated by the marketplace. Since marketers would directly bear the cost of certifying their products, they would face the strongest incentives to ensure certification is cost effective.

6.5. Accordingly, there seems little justification for retaining the existing structure of the producer boards in order to manage:

- licensing requirements for meat exporters, as provided for in Part IV of the Bill, except where that is necessary to allocate and manage access to country-specific tariff quota markets;
- meat export requirements provided for in Part V;
- quality requirements for meat provided for in Part VI;
- carcass descriptions provided for in Part VII; and
- quality requirements in respect of wool in Part XVIII.

6.6. Despite the protections in the Bill, the powers of the producer boards in respect of the above requirements also represent a risk to stakeholders and make the sector less attractive to investors. Some powers, like those relating to the imposition of export requirements for meat in Part IV, are broad and would be exercised only in response to restrictions imposed by authorities in overseas markets. However, in the event of such restrictions being imposed, an individual company could be adversely affected by majority decisions, which means that commercial risk in the industry is unnecessarily increased.

6.7. Moreover, to the extent that market restrictions or requirements do not relate to valid hygiene or sanitary concerns, they amount to non-tariff barriers in respect of which remedies are being developed under the rules of the World Trade Organisation. It is therefore doubtful whether the full range of restrictive powers set out in Part IV is either required or appropriate, since it is conceivable that their existence might invite the imposition of non-tariff restrictions.

6.8. In summary, the NZBR concurs with the minister of agriculture that grading powers should be removed from the Bill. Likewise, the ability of the boards to set quality standards in Parts VI and XVIII should be removed. This will ensure that

statutory interventions do not cut across normal market signals that suppliers convey to consumers, nor impede the independent enhancement of brands and reputation.

## 7 ACCESS TO TARIFF QUOTA MARKETS

7.1. As part of its powers to impose export requirements, the Meat Board will be responsible for establishing and administering mechanisms for the allocation of access to tariff quota markets (provided under Part V of the Bill).

7.2. Quota restrictions are a diminishing problem for New Zealand's meat and wool markets. As a result of the GATT Uruguay Round, quotas have been liberalised and the trend is for them to be replaced over time with tariffs. Quota access applies in respect of the European Union and (in the case of beef) the United States and Canada. However, it is now only in respect of exports to the European Union that volume limits are reached.<sup>19</sup> In the specific case of that market, there is a role for statutory arrangements for the time being to ensure that rents (net of any costs of setting up and administering a quota system) created by restricted access are not dissipated. The Bill does not address the issue of how the quota should be allocated. Instead, the job of establishing a mechanism is left to the Meat Board. However:

- the administrative requirements to operate and manage an allocation mechanism are not extensive; and
- there is no particular reason why the board should be retained solely for this purpose. For example, if allocations to the European Union and the United States were established as property rights and, once allocated, were valued and traded according to their commercial merits, the ongoing involvement of any external agency would be minimal. Other allocation mechanisms would also be possible without producer board involvement.

7.3. The issue of access to tariff quota markets is now a relatively minor one. The administration of export licences and other valid export restrictions is more appropriately a government function (as was the case with import licences) than an industry function. The job of devising and allocating quota access could be given to a small, special purpose agency with a limited life set up for the purpose. Alternatively the job could be given to the Ministry of Agriculture (which, prior to the advent of the Ministry of Fisheries, had responsibility for allocating quotas for fish stocks).

## 8 ACCOUNTABILITY ARRANGEMENTS

8.1. A review of the grounds for statutory intervention shows that valid grounds for intervention (taking account of associated costs) potentially exist only in respect of markets where access or other restrictions apply, and this justification is likely to apply to just one market (the European Union), and for a limited period. This ground for intervention does not justify maintaining the infrastructure of the boards as envisaged by the Bill.

8.2. The producer boards are also poorly suited to be bulk funded from levies to undertake a wide range of activities (market access, promotion, research etc.). This arises from the following incentive problems:

- capital market constraints on the performance of the boards are relatively weak. For example, management is not exposed to the threat or reality of

<sup>19</sup> Over recent years New Zealand's beef exports to the United States have fallen well below the permitted quota level.

takeovers and information generated by the sharemarket reflecting management performance is absent. While this applies particularly to boards as a holding entity, producers have found to their cost over the last decade that incentive problems also arise for subsidiaries owned or controlled by the boards;

- accountability to producers is primarily through political processes and pressures which leads to the use of political, rather than commercial, decision criteria. A continuing and substantial role for the producer boards in funding research and promotion makes it easier for special interest groups to lobby to invest funds in low-yielding activities. There are still calls by some in the sector for the boards to invest in "a string of commercial companies", ignoring costly lessons of the past.<sup>20</sup> The chief executive of the Meat Board is reported as being keen to see the board's \$70 million in reserves used to fund a range of partnerships with local and overseas companies.<sup>21</sup> Private investment will be deterred where the powers and resources of the boards can be used in a selective and arbitrary fashion. Lobbying to maintain or increase spending on favoured, but low-yielding, activities can be successful since decision making is intermediated through industry politicians rather than through the far stronger accountability mechanisms applying to commercial activities;
- the producer boards have confused and overlapping objectives. The general policy statement notes that the objects which spell out what each board is to achieve "... are intended to strike a balance between the boards' accountability to their levy payers, their responsibilities to the wider industry, and the national interest". These objectives will often conflict, which means that any shortcoming in meeting an objective can be attributed by the boards to a requirement to pursue another;
- as ultimate owners of board-owned assets, producers have relatively weak incentives to monitor the performance of the boards and their management. This is because producers are not able to act directly on information they receive about board performance, for example by buying and selling shares; and
- the activities of the producer boards can overlap with those of the government, resulting in waste and a confusion of roles. The minister of agriculture has questioned spending by the boards on market access.<sup>22</sup> He pointed out that this is properly a role of the government, assisted where appropriate by organisations that represent direct stakeholders, such as the Meat Industry Association and Federated Farmers (with these organisations having an incentive to work jointly where their interests coincide).

8.3. The above incentive problems are heightened because the objectives of producers may conflict with those of the boards. The interests of producers may be better served by the boards distributing their reserves or liquidating assets and returning the proceeds. The interests of management or of the boards may lie in retaining earnings and investing in politically popular ventures that, due to poor

<sup>20</sup> *NZ Herald*, 21 March 1997, p. C4. The Bill provides few impediments to the boards in the future deciding to expand their role in commercial subsidiaries. In this context, Wool Services International is a recent salutary illustration of why producer boards are poor vehicles for commercial decision making. The Wool Board's decision to acquire the venture followed its decision to terminate its involvement with minimum pricing arrangements, and reflected its desire to find another role for itself. The poor performance of the company cost producers dearly.

<sup>21</sup> *Rural News*, March 10, 1997.

<sup>22</sup> *NZ Herald*, 21 March 1997, p. C4.

returns or risk, would not be undertaken by an entity subject to normal commercial disciplines.

8.4. A further point is that, because of the conflicting objectives of producers and the boards, spending on favoured marketing or research strategies may not accord with producers' spending and investment preferences. The preferences of producers are unlikely to be uniform because they face vastly different circumstances. Many are currently hard pressed to pay for necessities such as food, housing and basic farm maintenance. They could be expected to put a low priority on promotion or the retention of non-core assets by the producer boards compared to retaining the levies they pay and receiving cash distributions from board reserves, both of which would increase their disposable incomes (in the order of 12 percent for the average sheep and beef farm). Producers who wish to invest in commercial assets could do so independently of the boards. Boards cannot reflect the preferences of each producer since their decisions affect all producers.

8.5. A similar point arises in respect of risk taking. The willingness of producers to take financial risks differs. The sale of the boards' remaining assets and the discontinuance of levies would reduce the risk producers face, or would enable them to manage their own risk according to their preferences. Many producers have limited opportunity to influence the decisions of the boards and have few options to offset the effect on them of adverse decisions. It is very costly, for example, to convert land uses to other, less encumbered activities.

8.6. As entities in which investors are captive, performance measures for the producer boards stipulated by the Bill, such as five-yearly reviews, while probably superior to none at all, are a pale reflection of the disciplines that apply in the private sector. The 1992 collapse of the kiwifruit industry occurred immediately after a statutory review which did not identify the serious weaknesses in the Kiwifruit Marketing Board's operations. Most importantly, it is simply impossible to establish the counter-factual through such reviews - what return could producers achieve if they had the ability to make alternative investments? Likewise, attempts to require more elaborate procedures for political accountability, for example by approving annual plans, requiring three-yearly votes or scrutinising spending by the boards on major initiatives, are merely a palliative. Such approaches confuse the role of stakeholders and management and do not address the fundamental weaknesses that arise from a reliance on political rather than commercial accountability.

8.7. These differences between producer boards and an investment vehicle in which stakeholders directly hold ownership interests mean that, on average and over time, resources invested through the boards are likely to achieve lower returns than if those resources were invested directly by producers. History to date underscores this conclusion.

8.8. The existence of the boards and their statutory powers also keeps alive the fallacy of 'producer control' that has bedevilled primary industries for decades. This fallacy is still manifested in movements like Farmers for Change and Meat and Wool Levy Payers, and has led to endless inquiries like the Weir Committee, the Cullwick Committee and the review that preceded the present Bill. Wool, meat and pork processors and exporters, politicians and unions can all fall into the trap of believing that if only they could use the resources and powers of the producer boards to achieve the right interventions or industry strategies, the forces of economic gravity would somehow be defied and downturns in markets that are beyond anyone's control would be reversed.

8.9. However, all the meetings, reviews and movements reflect a failure to understand the disciplines of competitive markets and sustain naïve ideas about collective ownership that are little different from those espoused in the former Eastern

bloc. They divert a great deal of time and energy of industry participants which would be better directed to business activities, whether on or off the farm.

8.10. The false sense of 'producer control' induced by umbrella organisations like the boards also diverts the attention of producers and others from the development of more conventional and successful forms of cooperation and coordination that are typical in other sectors (such as sophisticated purchase contracts where there is seasonal demand or supply). Rather than trying to tamper yet again with the architecture of the boards, they should be dispensed with once and for all.

## 9 CONCLUSION

9.1. The meat and wool industries have been prone to regular crises for the past 20 years. Their development has been plagued by government and producer board interference that has been grossly distorting. They are also continuing to suffer from the effects of inappropriate controls in the dairy sector.

9.2. Existing structures in the meat and wool industries were criticised in the NZBR report *Agricultural Marketing Regulation: Reality Versus Doctrine* (1992). Since that time there has been a significant shift in thinking and a wider recognition of the extent to which the pervasive role and powers of the boards have cast a shadow over the sector. Even the review of institutional arrangements in the meat and wool industries undertaken by Federated Farmers in 1994 and the introduction of the Bill have been overtaken by events. There is now a great deal of questioning, including by people who are close to them, about whether the boards are needed at all.

9.3. The meat and wool industries are slowly recovering from the adverse effects of past interventions. There is no reason to believe that both industries, and the pork industry, should not have a good future. However, to secure a viable future, these industries must match the rates of improvements in innovation and productivity of other sectors in a better performing economy. Otherwise, they will lack profitability and be unable to compete successfully for resources. The sectors must therefore be freed from all unnecessary handicaps and distractions.

9.4. This submission has established that any special factors that make the industries covered by the Bill stand out from others are minimal. The very limited grounds for government intervention that exist do not warrant retention of the full paraphernalia of the producer boards. The only significant one which remains valid for the time being is access to quota markets with significant rents, and this could be handled by giving licensing powers to a government agency. Moreover, retention of the boards leaves open the likelihood that the sectors will continue to be plagued by political manoeuvring and pressures which divert commercial effort unnecessarily.

9.5. Accordingly, we submit that the Primary Production Committee should step back from the detail of the Bill and consider how the industries it covers should be put on a more certain and durable long-term footing. In particular, it should recommend either:

- that the boards be wound up with the proceeds from the sale of their assets sold and distributed to levy payers; or
- that the boards to be reconstituted as companies with shares allocated to producers.

9.6. In either case, the proceeds or shares could be distributed on the basis of previous levy payments. Reconstituting a producer board as a conventional company subject to normal commercial disciplines would be appropriate if it is desirable to

retain the assets of the boards, including ownership of brands that have a positive market value. Once reconstituted, the new entities would be as free as any other company to engage in joint ventures, purchase commercial operations or charge royalties for the use of brands they own. Likewise, producers would be free to retain or sell their interests in the new entities.

9.7. If producers wish to continue to fund promotion or research through a compulsory levy, they could use the provisions of the Commodity Levies Act 1990. While this Act might be improved,<sup>23</sup> it has a number of advantages over bulk funding boards to undertake a variety of tasks:

- there is more flexibility for levies to be targeted for particular purposes, for example, research as distinct from promotion;
- unlike the case with the meat and wool boards, levies cannot be spent on any commercial or trading activity unless either specific approval is given by the minister of agriculture or commodities are bought and sold for certain other limited purposes (such as those associated with promotion, research, education or product development); and
- levies to fund particular activities have a limited life, whereupon a fresh mandate is required from levy payers.

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Some of the problems with the Act are referred to in Ministry of Agriculture (1996), 'Post Election Brief: Policy Issues and Current Status of the Agriculture Sector', Wellington, p. 50-51.

**AIC 1997 NEW ZEALAND WATER MANAGEMENT  
CONFERENCE**

**REFORM OF NEW ZEALAND'S  
WATER UTILITIES  
THE SNAIL'S PACE OF PROGRESS**

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

**AUCKLAND  
24 MARCH 1997**



## REFORM OF NEW ZEALAND'S WATER UTILITIES: THE SNAIL'S PACE OF PROGRESS

The focus of this paper is on options for greater private sector involvement in the water and wastewater sector. This is not to suggest that I think privatisation is the only option for reform. To the contrary, I believe that substantial economic and environmental gains can be achieved by steps such as metering of water, efficient pricing, establishing Local Authority Trading Enterprises (LATEs), reorganising bulk and retail supply arrangements and improving institutional arrangements for water allocation, particularly by introducing clear property rights and tradable permits. These topics were the primary focus of the 1995 New Zealand Business Roundtable report *Reform of the Water Industry*. Only five pages of that 150 page study were devoted to consideration of the benefits of privatisation – although inevitably they attracted the most attention.

My impression is that the general arguments presented in that report on commercialisation and structural reform issues are now fairly well accepted among water industry managers. Opposition to these concepts comes mainly from organised interest groups and politicians. But there is a large gap between conceptual thinking and implementation. Actual reform in the industry is still proceeding at a snail's pace, and opportunities to achieve both economic efficiency and environmental goals are not being taken.

Steps short of full privatisation should probably be the first priority in a reform programme. However, given the state of professional thinking, a discussion of the possible additional gains from privatisation may be of greater interest than a general rehearsal of the benefits of commercialisation. Although privatisation is perceived by many in New Zealand as a controversial issue, I would be surprised if most industry professionals did not also see advantages in various forms of private sector involvement in the water industry. Already substantial efficiency gains have been achieved by most councils through contracting out council services to the private sector (for example, refuse collection, road maintenance, pipeline repair and so on). There is every reason to suppose that many aspects of the supply of water services offer the same potential.

This paper begins by reviewing the general case for privatisation, with emphasis on the local government level. I then discuss the variety of ways in which overseas countries are privatising their water and wastewater industries. In the final section I review the progress that is being made in New Zealand in reforming the industry and examine some of the arguments that continue to be raised against corporatisation and privatisation.

### **The Case for Privatisation**

The conversion of government trading departments to state-owned enterprises (SOEs) and the exposure of their markets to competition have brought large efficiency gains, as even former critics of these reforms now acknowledge. But the further issue of public or private ownership also matters. There is now a large body of evidence that, on average and over time, privately owned businesses perform more efficiently than state enterprises. Around the world the first wave of privatisation of state businesses has been followed by privatisation of various utilities (for example, ports, airports, telecommunications, electricity, water and roading), and the current wave is seeing an extension into social services such as health and education. The inescapable fact is that businesses exposed to the disciplines of capital markets and monitoring by interested owners have stronger incentives to perform than those merely subject to political oversight.

Short of full privatisation, other options for private sector involvement in infrastructure provision can also bring significant efficiency benefits. However, because none of them entirely severs the relationship with government, the fundamental incentive problems of government ownership will remain. In addition, these arrangements all require an ongoing contractual relationship between the private sector and the government. The complexities of managing such a relationship should not be underestimated, and governments are often influenced by political rather than economic priorities.

Increased involvement of the private sector can bring skills and know-how that is not otherwise available to governments. In particular, the private sector can mobilise finance for new investments when governments are hard-pressed to raise funds for the large outlays required for infrastructure investments, and it is better placed to manage business risk. Businesses can be set free to develop long-term business strategies, which may include an international dimension. Privately owned water utilities in France and England, for example, are a new source of competitive advantage for those economies and they are marketing their services worldwide. Taxpayers' and ratepayers' equity in such publicly owned businesses cannot responsibly be put at risk in such activities.

Long-term local government ownership and operation of water and wastewater assets is not a desirable option. With continued public ownership we are likely to see:

- ongoing politicisation of decision making;
- lack of clarity as to objectives;
- rent seeking and political grandstanding over issues such as metering, pricing and ownership;
- poor information about the condition of assets;
- poor investment decisions and decisions not made in a timely fashion; and
- weak incentives to control costs.

These difficulties will be particularly severe if councils fail to establish LATEs. However, experience suggests that the gains from corporatisation become eroded over time as political interference re-emerges. One of the additional benefits of privatisation is that it locks in the gains of corporatisation.

Three recent reviews of privatisation experience provide empirical support for the general case for private ownership, including of utility businesses.

The first study, conducted by the World Bank, looked at the post-privatisation performance of twelve companies (mostly airlines and regulated utilities) in Britain, Chile, Malaysia and Mexico.<sup>1</sup> It carefully separated the impact of privatisation from other influences in comparing the performance of the companies before and after privatisation. The study concluded that net welfare gains resulted from privatisation in eleven out of the twelve former state enterprises.

A second report by the World Bank reviewed a much larger sample of companies – 61 companies in 18 countries (six developing and 12 industrial) and 32 industries – that

<sup>1</sup> Galal, A, Jones, L, Tandon, P and Vogelsang, I (1994), *Welfare Consequences of Selling Public Enterprises*, New York: Oxford University Press.

had been privatised through outright sale.<sup>2</sup> The study found that following privatisation, efficiency improved on average by 11 percent; investment increased by 44 percent; output increased by 27 percent; employment was up by 6 percent; and profitability and dividends were significantly higher.

The third study, conducted by the Reason Foundation, compared privately owned and government-owned water systems in California.<sup>3</sup> This study is particularly interesting because it focuses specifically on water, and for two other reasons. The first is that private water companies in California are heavily regulated and there is no a priori reason to assume that in such an environment they would consistently outperform government-owned firms, given the poor incentives to increase efficiency. Secondly, the government-owned companies received special treatment in the form of tax subsidies, excess cash balances and investment income. Yet despite these factors the study found that, because they were substantially more efficient, the privately owned companies provided water services to consumers at the same price as government-owned water companies without subsidies or tax exemptions. For example, the government-owned water companies had 3.49 employees on average per 1000 connections, more than twice the level of private companies, and salaries were much more inflated in the public agencies – over 37 percent of operating revenues in the public sector companies against 13.4 percent in the private ones. The study concluded that government provision should be terminated, with the financial savings being applied to tax reductions or higher priority government programmes.

The evidence on the general benefits of privatisation is now decisive. As the World Bank put it in the 1996 *World Development Report*, there is little doubt that private ownership is a significant determinant of economic performance in established market economies. Opposition to privatisation can now only be based on ideology, not logic and evidence.

### Water Privatisation in Britain

The British experience with water industry privatisation is often criticised. Indeed it seems to be the only example of water privatisation known to Alliance politicians and many journalists, and they seem to think it demonstrates the failure of privatisation.

The heavily regulated approach adopted by the British government is certainly not a model that commends itself. In many ways the industry swapped a government owner for a government controller and regulator. However, it is important not to overlook the context of privatisation in Britain. Substantial investment was required to enable the water companies to catch up on maintenance which was neglected when they were under political control, to meet strict European Union environmental standards (whether justified or not), and to improve the quality of drinking water. Funding this investment meant that, regardless of privatisation, prices would rise and consumers who did not value such quality improvements would be dissatisfied. In fact, charges have risen in all European Union countries, in part as a result of the need to finance investment needed to meet higher quality standards.<sup>4</sup>

Furthermore, a rise in prices following corporatisation or privatisation is not necessarily an indicator of policy failure. If prices were previously held down

<sup>2</sup> Megginson, W L, Nash, R C and van Randenborgh, M (1996), *The Privatisation Dividend: A Worldwide Analysis of the Financial and Operating Performance of Newly Privatised Firms*, World Bank.

<sup>3</sup> Neal, K, Maloney, J, Marson, J and Francis, T (1996), *Restructuring America's Water Industry: Comparing Investor-Owned and Government-Owned Water Systems*, Reason Foundation.

<sup>4</sup> Smith, J (March 1996), *Directions in Water Pricing: A UK-European Focus*, paper presented to 1996 AIC New Zealand Water Supply Conference, p. 2.

artificially – for example through failure to undertake adequate maintenance of assets, or for political reasons – over-consumption and other distortions would occur, causing resource misallocation and environmental damage. Artificially low prices are as harmful to society as artificially high prices – the goal should be to promote efficient pricing.

In respect of pricing, it should also be mentioned that the lack of metering in Britain has restricted the efficiency gains that might have been expected from privatisation – only 7 percent of domestic households have meters. Ninety-three percent of households still pay on the basis of rateable value (property values previously used by local authorities for raising revenue).<sup>5</sup>

It is sometimes suggested that the rate of investment being undertaken by the private British water companies is sub-optimal. However, determining the optimal rate of investment is not straightforward. In an unregulated market, private owners have strong incentives to optimise the extent and timing of their investments. Firms maximise their profits by investing in projects to provide services which customers are prepared to pay for. It is possible that the regulatory regime in Britain is distorting the investment incentives of the private water companies. If the private utilities fear that the regulator will not allow them to set prices that cover the costs of future investments, they may indeed be reluctant to commit to capital projects.

Despite these significant weaknesses in the implementation of water industry privatisation in Britain, the balance sheet of the results is clearly positive. Real improvements in drinking and bathing water quality have been achieved, and efficiency gains made. For example, Anglian Water reports that compliance with drinking water standards has increased from 98 percent in 1989 to 99.6 percent in 1995; compliance with wastewater standards has increased from 80 percent to 98.7 percent; and the loss rate from the distribution system has been reduced from 16 to 13 percent. Customer service has also improved.<sup>6</sup> Importantly, Anglian Water has estimated that (as at 1993/94) prices were 13 percent lower than they would have been if the company had remained in government ownership.<sup>7</sup> Whatever the merits of the debates about issues such as the salaries of managers in the water industry, such cost factors have been swamped by these efficiency gains.

### Water Privatisation Around the World

Many governments are proceeding with privatisation because they are convinced of its benefits. Robert Poole of the Reason Foundation noted in an address in New Zealand last year that the sale of state-owned enterprises around the world totalled US\$66 billion in 1995, bringing the 10-year total of such sales to US\$535 billion.

The worldwide trend towards increased private involvement in infrastructure assets has extended to the management, operation and ownership of water and sanitation assets. Increased private sector involvement has been achieved through management contracts, leases, concessions, build-operate-transfer (BOT) schemes and, of course, divestiture.<sup>8</sup>

<sup>5</sup> *ibid*, p. 1.

<sup>6</sup> Latham, D (1996), *UK Water Experience – What Can New Zealand Gain?*, paper presented to the 1996 AIC New Zealand Water Supply Conference, p. 19.

<sup>7</sup> Matthews, P (February 1994), *Anglian Water: A Successful Example of Privatisation*, paper prepared for publication in Brazil, Ref: Elaine Santos Vega Sopave, p. 3.

<sup>8</sup> The discussion below draws on the World Bank (November 1996), *Toolkits for Private Sector Participation in Water and Sanitation*, Second Discussion Draft, pp. 6–12.

*Management contracts* transfer responsibility for the operations and maintenance of government-owned businesses to the private sector for a relatively short period (three to five years typically). Such contracts leave responsibility for all investment with the government owner of the assets. Management contracting is likely to be most useful where the primary objective is to enhance the technical ability of a utility to perform specific tasks. Management contracts can be used as a first step towards private involvement where current conditions make it difficult for the government to contemplate other forms of privatisation, or where it is difficult to induce the private sector to commit capital or take commercial or political risks.

Management contracts have been adopted in Colombia, Malaysia, Trinidad and Tobago, and Turkey for water services, and in the United States for both water and sanitation services. In Mexico City, management contracts have been used as an interim step to improve information about the state of the system prior to seeking investment commitments from the private sector. Management contracts are being considered in Angola and Albania.

Another option involves *leasing* infrastructure assets to the private sector. Under a lease arrangement, a private sector company takes responsibility for operating and maintaining the assets. In a well structured contract, the private sector partner accepts a significant share of the commercial risks. For example, the contract may allow the private sector party to increase its profits by cutting its costs. Leases have been used where there is scope for gains in operational efficiency but only limited need or scope for new investment. The responsibility for financing new investments remains with the government owner.

Leases have been used extensively in France and Spain and are currently in place in Guinea and Senegal.

One of the preferred approaches to increasing private sector involvement has been the use of *franchising concessions*. Under a concession, the private company takes on full responsibility for the operation and maintenance of the asset, as well as for investments. Asset ownership remains with government. The concession approach passes full responsibility for operations and for raising finance and investment to the private sector for a period typically of 25–30 years. A concession arrangement can harness private sector incentives for efficiency across a range of the utility's assets. Administration of the concession by the government is, however, complex.

Concessions have long been used in France. This approach has now been adopted by a number of developing countries. In a recent report the Global Environment Fund identified more than 150 recently completed, ongoing and soon-to-be awarded projects, involving more than US\$25 billion in private investment. Most of the projects involve private concessions in water and wastewater management. Examples include a US\$4 billion concession awarded in 1994 to a private sector consortium for operation of the Buenos Aires water and wastewater operations, and a US\$1.2 billion concession awarded for Santa Fe's water and wastewater system in 1995. Concessions have also been granted in Brazil, Colombia and Mexico, and are under consideration (or in the process of being tendered) in Bolivia and Ecuador. A US\$2.2 billion concession for the operation of the Casablanca (Morocco) municipal water, wastewater and electric operations was negotiated in 1996. Malaysia awarded a US\$2.8 billion country-wide wastewater concession in 1993 to a private consortium. A US\$1.3 billion water concession has been granted in Thailand. The Philippines government recently announced the US\$7.5 billion privatisation of the Manila water supply through a concession arrangement.

*Build-operate-transfer* (BOT) arrangements are similar to concessions, but are generally used for new projects. The primary advantage of this approach is that it can mobilise private sector incentives and finance for costly new investment projects. Variations

on this approach include BOT arrangements in which ownership remains with the private sector.

BOTs are being used to develop the major new treatment facilities for Sydney's water supply, and proposals for sewage collection and treatment are being considered. A BOT has been adopted by Wellington City Council for its wastewater treatment plant. BOT concessions have been granted in Colombia, Shanghai, Turkey and Oman. Future BOT wastewater and/or water concessions have been announced in Brazil, Chile and India.

The final option, that of *divestment* of water or wastewater assets, transfers to the private sector full responsibility for operations, maintenance and investment. Probably the greatest benefits, including the minimisation of the risks of political interference, are available under this option.

Asset sales have been used widely for the privatisation of non-water infrastructure assets. In the water industry, by contrast, large-scale asset sales have to date been confined to the privatisations in England and Wales. Private water companies have, however, operated for a long time in the United States, and some privatisation of water and wastewater assets has occurred there. Chile is considering asset sales (or a concession). A tender of a 25 percent stake in Budapest's municipal water company is proposed for 1997/98.

### **Arguments Against Corporatisation and Privatisation**

Compared with the momentum of reform of water utilities around the world, progress in New Zealand has on the whole been extremely slow. Debate seems to have foundered on the same hoary arguments that were raised against earlier corporatisation and privatisation proposals.

For example, Stuart Macaskill, chairman of the Wellington Regional Council and former president of the then Local Government Association, has repeatedly come up with spurious arguments against privatisation and contracting out. Recently, he opposed the decision by the Wellington City Council to tender out maintenance of its water supply and argued that his council should be given a regional monopoly. Fortunately, the replies by the mayor and other Wellington City Council members were robust: the regional council had been slow to fix leaking pipes, it had done a "lousy job" and "he is trying to protect his patch".

It is sometimes suggested that because water businesses have some 'natural monopoly' characteristics they cannot be privatised for fear they will abuse a market position. However, if monopoly pricing is a concern with private ownership, it is equally a concern with LATEs, which also have commercial goals. Thus the issue of monopoly pricing must be considered at the time LATEs are established, and no additional issues are raised by privatisation. In my view, a light-handed regulatory regime, involving reliance on information disclosure and the provisions of the Commerce Act 1986, appears likely to interfere least with commercial decision making while providing a constraint on any market power that suppliers of water and wastewater services might have. Experience has shown clearly that cost padding and monopoly pricing were far greater problems in utilities such as ports and electricity supply authorities when they were under political control, and the same is almost certain to be true of water.

Another objection to the commercialisation of water businesses and charging for consumption is that poorer households would be harmed. This argument cannot be sustained. Low income households are often low users of water compared with those with swimming pools and large gardens which are subsidised by the rest of the

community in the absence of metering. A study of the impact of changes to water tariffs on householders undertaken by the Wellington Regional Council concluded that "of those houses that would be worse off [from a change to usage-based charging], an assessment of the relationship to household expenditure suggests that for most households the cost increase would be affordable".<sup>9</sup> This study did not take into account the efficiency benefits likely to be achieved by commercialisation. A recent editorial in a Chilean newspaper criticised a political party for opposing privatisation, warning that the common people of Chile would be the losers, "above all, those sectors with the smallest incomes".<sup>10</sup>

If there are remaining concerns about the ability of some families to pay for water, these should be addressed directly through income support, rather than through sacrificing the cost saving and environmental benefits achievable by metering. However, the cost of water needs to be kept in perspective – the average weekly cost of water to a New Zealand household amounts to less than it spends on lotto and other forms of gaming. It is interesting to note that *The Australian Financial Review* stated in an editorial last year that "the politics of paying for water ... has never been a significant issue" in Australia. This may say something about the quality of the political leadership of some New Zealand councils.

An objection raised in the recent debate on the corporatisation of the Auckland City Council's water business was that "an essential commodity should not be treated as a profit-making business". However, water is an economic good like any other. People derive benefits from its consumption and, if it is priced correctly, will trade off the benefits of using additional water against other goods or services they might prefer. In any case, the Council must generate sufficient revenue to pay for the water services it provides. At issue therefore is how the revenue is raised, not whether it is raised. Most other essential commodities are provided by the private sector. Food, for example, is as essential to life as the small proportion of water use that is genuinely in this category, yet not even the Alliance would suggest that the production and distribution of food should be turned over to local government.

In opposing the establishment of a LATE, Auckland mayor Les Mills said that "he could not quite grasp the correctness of the principle of a wastewater user charge as wastewater disposal was a public good". While it is true that there are some 'public good' benefits from wastewater disposal (there are health benefits to neighbours from a household's safe disposal of waste), there are substantial private benefits as well. Levying a charge for the disposal of effluent would tend to reduce effluent and associated pollution. However, it is likely to be excessively costly to measure the discharge of effluent from residential and smaller commercial properties. Instead, it may be efficient to base sewerage charges on water consumption given the correlation between water use and effluent discharged into sewers. For industrial customers it would be efficient to levy charges based on the volume and concentration of effluent.

In the Auckland City Council debate, some councillors argued that corporatisation should be opposed because it might lead to privatisation. This is a bizarre form of logic. Privatisation might follow corporatisation if councils were satisfied that it would lead to further efficiency gains. However, the view that corporatisation must lead to privatisation seems to reflect an extraordinary lack of faith in democratic decision making. Privatisation only follows if council approval is given.

<sup>9</sup> Brunson Cathie Ltd (1993), *Wellington Metropolitan Water Supply Universal Metering Study Consolidated Report*, December Update, p. 13.

<sup>10</sup> *La Tercera*, 16 December 1996

Another criticism of privatisation has been made by Wanganui Mayor Chas Poynter. He suggested that "when you privatise, the person who takes over wants a return and the ratepayer will end up paying more". This argument is also spurious. Government organisations, like private ones, must cover the full economic cost of all resources, including the cost of labour and a return on capital employed. There is nothing intrinsic to a government organisation which means it faces lower capital costs than private firms. The difference is rather who pays and under what conditions. Thus, while council-owned entities may receive a capital subsidy from the council (and ultimately ratepayers), this does not mean that they produce goods and services at a lower cost to society. Instead, it means that ratepayers providing the subsidies bear part of the cost of production. For example, the cost of equity to the council organisation is the opportunity cost of the invested capital. The cost is borne in part by ratepayers who forgo any return to their capital contributions. In addition, privatised businesses such as Telecom have dramatically lowered the cost of a bundle of services to consumers despite paying taxes and dividends because of the massive efficiency gains they have achieved.

### **The State of Play with Water Industry Reform in New Zealand**

Some progress in reforming water and wastewater businesses is being made. Many councils have reviewed the option of setting up LATEs or stand-alone business units for their water operations, and some have opted for corporatisation.

The Far North District Council is one council which is going ahead with establishing LATEs for its water and wastewater operations. Wellington City has adopted voluntary metering and, as noted, is tendering out the maintenance of its water supply. It has also contracted with a private company to convert the solid residual from sewage treatment into compost. The Lower Hutt and Upper Hutt councils have announced that they will be calling for tenders to design, build and operate a sewage treatment plant. Papakura District Council is one of the few councils that has opted for more extensive private sector involvement in its operations – it has decided to franchise its entire water supply and sewage disposal services to a private operator and has received four bids, three of which are from private companies and one from Watercare Services. Private forms of water supply have been in place for many years in Oamaru and on Waiheke Island.

However, despite the progress by some councils, overall the reform of the water and wastewater businesses is occurring at a glacial pace. It is extraordinary that Wellington City Council seems likely to opt to charge for water services on the basis of the rateable value of properties. Despite a great deal of work by industry professionals, many councils in Auckland and elsewhere are still debating whether or not to form their water operations into LATEs or business units. Decisions about future water supplies in Auckland remain mired in local politics. Central government is dragging the chain on removing obstacles to water industry reorganisation and more efficient pricing. Stuart Macaskill has even urged central government to put greater obstacles in the way of water privatisation. Businesses and residents should simply not be putting up with this totally unsatisfactory state of affairs.

While New Zealand is spinning its wheels, governments elsewhere are moving on, not just in other parts of the world, as noted earlier, but closer to home as well. The Victorian government has corporatised its water businesses, and privatisation may not be far down the track. In South Australia, a \$1.5 billion contract has been entered into with British and French companies to supply Adelaide's water, and partial privatisation is underway in New South Wales. With moves afoot in other states, it is galling to see Australia, not known as a leader in microeconomic reform, moving well ahead of New Zealand.



The Business Roundtable report *Reform of the Water Industry* (1995) put the accumulated investment by local government in water supply and wastewater assets at around \$6 billion in 1995. This is larger than the investment in Telecom's national network. Since the corporatisation of Telecom, the annual gains to the New Zealand economy have been estimated in a Victoria University study to be of the order of half a billion dollars, and the gains since privatisation have been at least as large as those in the SOE period. This could be the order of magnitude of the gains New Zealand is sacrificing by not pressing ahead vigorously with water industry reform. Councils and central government need a wake-up call, and they need it now.

**SUBMISSION BY THE  
NEW ZEALAND BUSINESS ROUNDTABLE**

**TOWARD A MORE EFFICIENT  
POLICY FRAMEWORK FOR GAMING**

**DECEMBER 1996**

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## EXECUTIVE SUMMARY

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- The review of the Department of Internal Affairs (the Department) of gaming, comprising commissioned studies, discussion papers and public submissions, is welcomed.
- The Department proposes to rationalise the fragmented regulatory environment for gaming. Its proposals would relax present restrictions but retain industry-specific controls on gaming.
- The Department's discussion paper *Gaming – A New Direction for New Zealand* (1996) does not contain a rigorous analysis of the costs and benefits of industry-specific regulation and taxation, and of the provision of gaming by government-owned operators. The analysis needs to be taken further to arrive at sound policy proposals on these matters.
- The supply and consumption of gaming are severely distorted by extensive regulation.
- Gaming is a popular form of enjoyment for people who choose to participate. The vast majority of gamblers act responsibly.
- Most costs that arise from problem gambling are borne by the participant and his or her household unit rather than by other members of society. Policies that target irresponsible behaviour rather than responsible gaming are required.
- The thrust of this submission is that the regulatory framework for gaming should be brought into conformity with that of other goods and services, except where there are valid public policy grounds for industry-specific interventions.
- The grounds for industry-specific intervention in gaming are weak. Past approaches to the regulation of gaming reflect moral concerns, paternalism and the desire to raise taxes, which attract limited opposition from the public. Most New Zealanders demonstrate by their spending decisions that they believe that gaming is an acceptable activity.
- A possible reduction in problem gambling and the risk of crime is unlikely to justify the costs which the present restrictions impose on the vast majority of responsible gamblers. In a more open and transparent environment, the risks of crime are unlikely to be greater than for comparable activities that are not subject to detailed restrictions.
- The lottery funding system channels large sums to administrators and Crown entities and away from the community groups that are the intended beneficiaries. It is very inefficient.
- The gaming review should establish an efficient regulatory framework that is appropriate for the twenty-first century. The key steps required include:
  - the abolition of the licensing of gaming operators. Present restrictions limit competition and waste resources by imposing unnecessary compliance and administration costs on businesses and the community. Any class of business, including for-profit firms, should be able to provide gaming. Firms should be permitted to decide the form of gaming that they

wish to provide. Transitional arrangements should recognise explicit commitments to existing operators and provide private firms with an opportunity to adjust to the new environment;

- the adoption of more appropriate rules on the participation in gaming by young people. Such rules should be soundly based, command the support of the community and be properly enforced. A lower minimum age for some forms of gaming is recommended;
  - the abolition of mandatory contributions to community activities and other industry-specific taxes. The social cost argument does not justify present arrangements. Gaming should be subject to the same tax regime as most other activities;
  - community activities that are currently funded by mandatory contributions from gaming should be funded out of general revenue and should be subjected to the same level of scrutiny as other government spending; and
  - the withdrawal of government agencies from the provision of gaming. This activity is beyond the proper role of the government. Its participation leads to inefficiency.
- The above measures would substantially increase the efficiency of the gaming industry, thereby conferring benefits on responsible gamblers and on the wider community through a better use of resources, including the reallocation of substantial administrative resources.
  - This submission's recommendations are presented in section 8.

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## GAMING REVIEW 1996

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### 1 OVERVIEW

This submission is made on behalf of 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. Of particular relevance to the present submission is the NZBR's view that consumer interests should be paramount in developing a policy framework for any industry.

People have participated in gaming for thousands of years. It was practised in ancient China, Egypt and Greece, and among the Israelites who drew lots to allocate land among the tribes upon entry into the promised land. Gaming seems to be common to most nations and cultures.<sup>1</sup>

Gambling has always been a pastime for New Zealanders.<sup>2</sup> The Department of Internal Affairs (the Department) reported that about 90 percent of the population gambles each year.<sup>3</sup> Those activities are obviously a source of enjoyment for people who choose to participate. This is best shown by their willingness to spend on gambling. Statistics New Zealand reports that, on average, households spent \$6.10 a week or 1.0 percent of their weekly expenditure on gambling in 1994/95. This amount is broadly comparable to that spent on fruit (\$7.40); pets, racehorses and livestock (\$6.40); footwear (\$5.90); and poultry and fish (\$5.50).<sup>4</sup> Such surveys typically understate spending on activities like gaming.

The vast majority of gamblers act responsibly. About 0.4 percent of the population aged 15 years and over (12,000) is reported to suffer from pathological gambling at any time and a further 2 percent are estimated to be problem gamblers.<sup>5</sup> Some gamblers may have exhibited pathological behaviour in any event. Most costs that arise from problem gambling are borne by the participant and his or her household unit and not by other members of society.

Present regulation severely distorts the supply and consumption of gaming. Policies that target its misuse rather than responsible consumption are required. This approach is similar to that taken in respect of compulsive eating. The increased availability of food is rightly seen as a benefit of higher living standards, and strategies to address eating disorders are targeted at their specific causes. The problem does not relate to people who eat a lot, but to those whose excesses endanger their health. A similar approach in respect of gambling requires policies directly targeted at its misuse.

The supply and consumption of gaming are heavily regulated. Different forms of gaming are subject to a variety of restrictions that cannot be justified by valid public policy considerations. The provision of particular forms of gaming, such as betting on horse racing and the use of gaming machines, is largely restricted to certain statutory

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<sup>1</sup> Department of Internal Affairs (1996b). A footnote remarks that this does not appear to be true of Maori.

<sup>2</sup> Statistics New Zealand (1996).

<sup>3</sup> Department of Internal Affairs (1996a).

<sup>4</sup> Statistics New Zealand (1995).

<sup>5</sup> Department of Internal Affairs (1996a). Some other sources put the level of pathological gambling at 1.2 percent. See Abbott (1992).

monopolies or licensed operators. Promoters and employees engaged in certain gaming activities are required to be licensed. Particular classes of enterprise, such as for-profit firms, are prohibited from the supply of most gaming activities. Government agencies are often preferred to other classes of providers. Unrelated activities, such as cultural and sporting pursuits, are subsidised by mandatory contributions (taxes) from gaming. Those disbursements are not subject to the same level of scrutiny that is applied to spending funded from general revenue.

These regulations and interventions extend well beyond those applicable to most other products and services. They reduce consumer welfare, impair competition and lead to higher prices and lower quality service than otherwise, waste resources from a community perspective and inhibit innovation.

The thrust of this submission is that the regulatory framework for the supply and consumption of gaming should be brought into conformity with that of other products, except where there are valid public policy grounds for industry-specific interventions. Many other products or activities – food, transport, sport and recreational activities and so forth – involve some risks to those using or taking part in them and the possibility of irresponsible behaviour, yet they are not subject to anything like the degree of control and taxation as gaming.

The prevention of crime and problem gambling is advanced by the Department as a valid reason for government intervention. The risks of crime with an open and competitive market for gaming are unlikely to be any higher than for comparable activities that are not subject to heavy-handed regulation. A possible reduction in problem gambling and the risk of crime is unlikely to justify the costs which the present restrictions impose on the vast majority of responsible gamblers. Some religious and other groups believe that gaming is morally objectionable. In a pluralistic society such views do not justify the imposition of restrictions on people who hold other views. Paternalism is a further reason that may help to explain the present restrictions on gambling. As we discuss later in the submission, the social cost argument for requiring gamblers to contribute to community activities and other industry-specific taxes is dubious.

Since 1984 successive governments have placed greater focus on their core role of setting the framework that enables individuals and firms to interact in ways that maximise community welfare. The supply of goods and services has increasingly been viewed as the function of private enterprise, except in certain exceptional circumstances. Competition has correctly been seen as the key to encouraging producers and distributors to satisfy consumer preferences at the lowest possible cost. The vast majority of New Zealanders endorsed these broad policy directions at the recent general election. The review provides an opportunity to apply them more consistently to the gaming industry.

There has been a gradual relaxation in controls on gambling since 1977 when the Gaming and Lotteries Act 1977 sought to make better provision for the conduct of games of chance, prize competitions, and lotteries for amusement and for raising funds for certain purposes. Earlier legislation had aimed to suppress many forms of gaming. Lotto was introduced in 1987. It now accounts for the largest share of the gaming market. The recent introduction of casinos represented a further step in easing the controls on gaming, and it re-established the principle that for-profit firms can be permitted to supply gaming services.

Although the Department proposes to rationalise and relax the present fragmented regulatory environment, its analysis needs to be taken further. The proposed policies, which are yet to be fully developed, do not go far enough in dismantling the heavy-handed and paternalistic regulation that distinguishes gaming from most other activities. In addition, the Department has not examined critically the government's

involvement in the provision of gaming and in the distribution of the net proceeds to community organisations.

A regulatory regime that will command wide support and is therefore likely to be sustained should be put in place. The public appears to have broadly accepted recent relaxations in gaming restrictions. The number of submissions received on the first phase of the review (70) was modest relative to those received on issues of greater concern to the public. The present review of aspects of the Sale of Liquor Act 1989, for example, generated about 400 submissions. The constructive process adopted by the Department in carrying out the review will promote confidence. The presentation of a quality analysis from a public policy perspective and the pace at which change is introduced are also important. Transitional measures, such as the phase-in of low barriers to entry into the gaming industry, should take account of explicit commitments to existing operators, and private firms should be given an opportunity to adjust to the new environment.

The present review should establish an efficient regulatory framework that is appropriate for the twenty-first century. The key steps required include:

- the abolition of the licensing of gaming operators. Present restrictions severely distort the supply and consumption of gaming. They limit competition and waste resources by imposing unnecessary compliance and administration costs on operators and the community. Any class of business, including for-profit firms, should generally be able to provide gaming, and they should be permitted to decide the form of gaming that they wish to supply. While there are grounds for denying people with convictions for offences such as fraud the right to operate certain gaming activities, they do not justify licensing of providers;
- the adoption of more appropriate rules relating to participation in gaming by young people. Such rules should be soundly based, command the support of the community and be properly enforced. A lower minimum age for some forms of gaming is recommended;
- the abolition of mandatory contributions to community activities and other industry-specific taxes. The social cost argument does not justify present arrangements. Gaming should be subject to the same tax regime as most other activities. Community activities that are currently funded by taxes on gaming should be funded out of general revenue and subjected to the same level of scrutiny as other government spending; and
- the withdrawal of government agencies from the provision of gaming. This activity is beyond the proper role of the government and its participation leads to inefficiency.

The above measures would substantially increase the efficiency of gaming, thereby conferring benefits on responsible gamblers and on the wider community through a more efficient use of resources, including the reallocation of substantial administrative resources.

The balance of this submission is presented in seven sections. The next section (section 2) addresses the grounds for government intervention. The regulation of the supply of gaming and the minimum age for gaming are examined in sections 3 and 4 respectively. Section 5 focuses on gaming duties and the funding of community activities. Government ownership of gaming operations is discussed in section 6. Brief comments are provided on the Department's policy proposals in section 7. Our conclusions and recommendations are presented in section 8.



## 2 GROUNDS FOR GOVERNMENT INTERVENTION

The central role of the government in relation to gaming and other industries is to establish a regulatory framework that encourages individuals and firms to take decisions that will maximise community or social welfare. The key task of the government is to define the set of rules that are most likely to facilitate the achievement of that objective. This overriding goal was omitted from the Department's paper.

Government intervention in gaming seems to have been justified in the past on the following grounds, most of which were mentioned by the Department:

- moral and religious objections to gaming;
- the risks of addiction to gambling;
- the costs imposed on other people (externalities) by pathological and problem gamblers;
- the risk of criminal activities;
- the protection of the consumer's interest; and
- the benefit of funding community activities through special taxes.

These arguments are considered in turn.

### 2.1 Moral and Religious Objections to Gaming

The view that gaming is undesirable on moral or religious grounds has been a main reason for its prohibition or control in many countries during much of the twentieth century. Some religious and other groups argue that gaming is an act of greed, it undermines the work ethic, it is inconsistent with the biblical injunction to love thy neighbour, it represents an improper use of money and reliance on chance interferes with God's plan for man.<sup>6</sup> These views are not shared by all religions or the vast majority of New Zealanders who participate in gambling. Only 6 percent of respondents to a 1990 survey raised such objections to betting on horse racing.<sup>7</sup> Furthermore, the potential harm to society generally from gaming is not sufficient to justify constraints on individual freedom by banning gaming.

Controls on the classes of gaming activities that can be supplied to the public, on their availability, and on the ownership of providers, together with industry-specific taxation, are doubtful instruments for addressing moral concerns. They do not overcome moral objections to gaming.

### 2.2 Addiction

The adverse social consequences of gaming, particularly those that arise from compulsive or problem gambling, are often cited as a ground for controls on gaming. The underlying premise is that addiction to gaming is inconsistent with rational behaviour and cannot therefore be left solely to individual choice. There are analytical and empirical reasons for rejecting this ground for intervention.

The central assumption of economic models of individual choice is that individuals are rational-utility maximisers with stable preferences. Becker and Murphy (1988)

<sup>6</sup> See Bell (1976), Munting (1996) and Rubner (1966).

<sup>7</sup> Reported by O'Sullivan and Christoffel (1992).

commented that, at first sight, addiction would seem to be "the antithesis of rational behaviour". They considered this question to be important because:

People get addicted not only to alcohol, cocaine and cigarettes but also to work, eating, music, television, their standard of living, other people, religion, and many other activities. Therefore, much behaviour would be excluded from the rational choice framework if addictions have to be explained in another way.

The traditional economic analysis of addictive goods treated addiction as a change in tastes (preferences). The consumption of the addictive product was postulated to increase the desire to consume and therefore to increase its consumption over time. The change in tastes was an alternative explanation to the possibility that increased consumption of the addictive product might be inconsistent with the view that marginal utility declined as consumption of a particular product increased. (This proposition is fundamental to a downward sloping demand curve.) Under the traditional view, tastes were "unchallengeable axioms of man's behaviour" that, "at least when held by an adult, are not capable of being changed by persuasion" (Stiglitz and Becker 1977). In an analogous context, Becker (1976) argued that the analyst had "succumbed to the temptation of simply postulating the required shift in preferences to explain all apparent contradictions to his predictions". Thus the traditional view offered little insight into the consumption of addictive goods and was inconsistent with the analysis applied to most goods and services.

Stiglitz and Becker (1977) challenged the traditional view. They argued that preferences neither change capriciously nor differ importantly among people. Thus "widespread and/or persistent behaviour can be explained by the generalized calculus of utility maximising behaviour" without introducing the assumption that tastes change. Stiglitz and Becker constructed a model in which beneficial and harmful addictions were dependent on a household production function that took account of what they termed "consumption capital". The model showed that harmful addictive effects are anticipated, as a result of which use is discouraged. Stiglitz and Becker also argued that harmful addiction is the result of an inelastic demand for the addictive product and not the cause of inelastic demand, as had previously been argued. The practical implication of this view is that, in the short term, increases in taxes on addictive products or activities are likely to have less effect on the demand for the addictive product by heavy users than on the demand by other consumers.

Becker and Murphy (1988) developed the analysis of Stiglitz and Becker. The former argued that addictions, even strong ones, are usually rational in the sense of involving forward-looking maximisation with stable preferences. In Becker and Murphy's model past consumption of the addictive product affects current utility through a process of "learning by doing" which is reflected in consumption capital. They defined a person as being potentially addicted to a product if an increase in his or her current consumption of the product increased his or her future consumption. This occurs if the person's behaviour displays "adjacent complementarity", where past consumption raises the marginal utility of current consumption.

Becker and Murphy suggested that a permanent change in the price of an addictive good may only have a small initial effect on demand but that the effect may grow over time. They also suggested that the demand for drinking and smoking could be quite responsive to price, yet the impact on demand for it by the most addicted might be modest. Stiglitz and Becker reached a similar conclusion. Becker and Murphy show that people who discount the future the most are more likely to become addicted.

Becker and Murphy also responded to the criticism that Stiglitz and Becker's model was unsatisfactory because it was claimed to imply that addicts are happy whereas real life addicts are often discontented and depressed. In Becker and Murphy's view, addicts would not be happy if:

... their addiction results from anxiety-raising events, such as death or divorce, that lower their utility. Therefore, our model recognizes that people often become addicted precisely because they are unhappy. However, they would be even more unhappy if they were prevented from consuming the addictive goods.

The essential conclusion from this research is that addiction can be examined within a standard utility-maximising framework. Potential addiction does not provide valid grounds for government action but does provide insights into the impact of policies that have been advocated to restrict consumption of gaming and similar activities.

This literature does not address the situation where a person's addiction is so excessive that he or she is unable to make rational decisions. In these extreme circumstances, society may require the government to take decisions on behalf of the affected person. The appropriate intervention is unlikely to be restrictions on the provision of addictive products or the imposition of indirect taxes. It may, however, comprise the appointment of a guardian for the person concerned, restrictions on his or her attendance at gaming establishments and a requirement to undertake appropriate medical treatment. None of these courses of action justifies the present regulatory framework for gaming.

These analytical arguments are supported by the observation that pathological and problem gambling is confined to a small number of people, as noted in the first section of this submission. It would be surprising if the level of problems in comparable areas, such as eating disorders, was significantly lower. According to research reported in an economic impact study, gaming is a price elastic activity.<sup>8</sup> This finding is inconsistent with the view that gaming is an addictive product.

### 2.3 External Costs Imposed by Problem Gamblers

The difference between private and social costs of gaming is advanced as a ground for regulating the supply and consumption of such activities. It is argued that significant costs arising from gaming are borne by society rather than the consumer or his or her household. Individuals are encouraged to consume excessive quantities of such services from a community viewpoint because they do not bear the full costs.

The standard efficiency criterion requires that marginal expected social benefits and costs be equalised. It follows that if individuals and firms take consumption and investment decisions solely on the basis of the costs and benefits that they face – private costs and benefits – and if there is a significant difference between private and social costs and benefits, community welfare may suffer. This could occur where the costs of one person's actions fall unwillingly on another. Because the first person would not take such costs into account, his or her decision may not be optimal from society's point of view. A similar argument would apply where unintended benefits accrue to an independent party. These differences between private and social costs and benefits are known as externalities.<sup>9</sup>

Externalities are pervasive and their presence alone does not justify government intervention. An externality arises, for example, when a passer-by gains pleasure from a private garden but the transactions costs of attempting to internalise such an externality (for example by charging for the enjoyment) would generally be excessive. Government action aimed at equalising private and social costs and benefits (or

<sup>8</sup> Coopers & Lybrand (1996). International studies are reported to suggest that an increase in price of 10 percent would reduce demand for gaming by 16 percent.

<sup>9</sup> More formally, an externality arises whenever one individual's actions affects the utility of another individual (Cowen 1988).

internalising social costs) can be justified only where the benefits of doing so outweigh the costs involved. The government might be able to address differences between private and social costs by specifying property rights (for example, the introduction of tradeable quota for fish), implementing subsidies or taxes, or regulation. These measures are not costless and thus the internalisation of all social costs and benefits is unlikely to be optimal.

A notable feature of gaming is that the cost involved is largely borne by the participant and his or her household unit. If, for instance, a gambler becomes addicted, the loss in income from gaming losses, reduced work effort or absenteeism falls on that person.<sup>10</sup> Similarly, the cost of forgone consumption is borne by the affected household. The costs do not generally fall on other members of society.

It is sometimes argued that the failure of the government to charge for the costs of most public health services, including the treatment of problems arising from gambling, creates an externality which justifies the taxation of gaming. This view is mistaken. The consumption of health services by one person generally has no direct impact on the utility of other people. It is the government's decision to impose taxes to finance health services rather than the consumption of those services that affects the utility of other people. The disposable incomes of taxpayers are reduced and their choices are biased.

The point that the consumption of subsidised health services does not constitute an externality can be illustrated by comparing two equivalent policy options. In the first the government gives people a grant to fund their health expenditures. In the second, it provides health services free of charge to the user. In both cases the expenditure is financed from general taxation. Both options increase the income of health consumers and reduce the welfare of taxpayers. However, neither constitutes an externality. No respectable analyst would argue that an externality arises when a superannuitant uses New Zealand Superannuation to purchase his or her groceries, yet that is analogous to the consumption of subsidised health services. (The issue of applying user charges or industry-specific taxes to fund health costs is examined below.)

Another externality argument is that gaming leads to crime such as theft and fraud. There have been instances where accountants and lawyers have stolen client funds to sustain their gambling. While the extent to which gaming leads to crime that would not otherwise be committed is unknown, it is clearly limited. Moreover, gaming is not the only activity that leads to such crime.

The principle to be applied is clear. The potential criminal will face the true cost of his or her crime if the expected cost of committing offences is set at an appropriate level. This cost is affected by the probability of being apprehended and the size of the punishment imposed. If people face inappropriate incentives, the best action is to adjust the probability of being apprehended, for example by increasing the effectiveness or level of resources committed to apprehension, and/or the level of penalties imposed.

A related externality argument is that crime adversely affects the welfare of victims. While this is a valid argument, the best solution to this problem is to enable the victim to obtain some level of compensation from the offender (where feasible) and to design punishments and enforcement procedures to provide optimal deterrence. The problem is that fines are paid to the Crown and compensation available to the victim

<sup>10</sup> Lost production is sometimes mistakenly identified as an externality. However, in equilibrium, wage rates are equal to the value of incremental output produced by employees. Thus the value of lost production as a result of impaired productivity and absenteeism is borne by the affected worker, other things being equal.

is often limited. This is a general problem that applies to all crimes and should be examined on a generic basis.

Another possible externality argument is that costs are imposed by gamblers on their families. These costs may arise from depression and domestic violence that is caused or accentuated by gaming losses and from excessive spending on gaming from the family's perspective. (External benefits may also arise, for instance if gaming were to reduce stress and depression.) However, losses from business investments may cause comparable external costs, but this would clearly not be a reason for seeking to suppress business investment.

If the family is viewed as a single unit, the possibility of a net external cost or benefit cannot arise. On the other hand, if individual members of a family are viewed as the appropriate unit, the possibility of an externality may arise. The solution to this problem centres on the rights and obligations of individual members of the family and their ability to enforce them. These include private agreements embodied in the marriage contract and customs, as well as the general legal framework (for example, prosecution for assaulting one's spouse or partner). Some costs imposed on families by one member are internalised, for example, when a family breaks up. The household unit often provides the appropriate unit of analysis because family members have greater scope to minimise the costs that they bear than strangers.

The government has a specific role in those cases where the interests of children are significantly at risk. The grounds for this action are that the parent as the agent of the child is demonstrably failing to act in the child's best interests. This general ground justifies the Department of Social Welfare's right to place children that are at serious risk of harm, perhaps through neglect, in foster care.

The misallocation of spending from the family's perspective is best viewed as an agency issue. It is difficult to envisage how existing regulation of gaming could effectively address this problem in a sensible way. The problem of abuse within families is not primarily related to problems arising from gaming, nor is it solved simply by gaming regulation. General solutions directed at the wider problem are necessary.

## 2.4 Risk of Crime

A separate rationale for the prohibition or control of gaming is that it is associated with crime. The Department of Internal Affairs wrote that:

Gaming is largely a cash based activity with, in some cases, no audit trail. These characteristics are seen as increasing the potential for crime and money laundering. Much of the present regulatory regime surrounding gaming of all types is aimed at controlling crime and fraud. Many forms of gambling have in the past been associated with crime and fraud and while this may be less obvious now than in the past, it is important to both the public and the industry that gaming operates in an environment where these problems are clearly seen to be avoided.

Several points can be made regarding this argument:

- in the United States, the most serious problems from a crime perspective arose when gaming was prohibited. The same observation applies to the prohibition of the sale of liquor. In New Zealand the ban on illicit drugs has been associated with significant criminal activity. In the case of hard drugs such bans may be justified, but the likelihood that they may give rise to serious forms of crime needs to be recognised, and a similar justification does not apply to gaming;

- the prohibition of certain gaming activities, other unjustified restrictions on the supply of gaming and the allocation of gaming licences through the political process create the very conditions that are conducive to bribery and corruption among politicians, regulators and law enforcement agencies. While New Zealand appears to have avoided such problems, other comparable countries, including Australia, have not been as fortunate;
- competition provides a better safeguard against fraud and dishonesty by operators than restricted entry into the gaming industry because it provides consumers with choice. It encourages firms to satisfy the preferences of consumers and maintain their reputations, and it creates incentives for owners to monitor the activities of managers and for managers to do the same in respect of their staff. In contrast, regulators have weaker incentives than owners to monitor managers and staff. Moreover, with a regulatory approach, who monitors the regulators?;
- competition reduces the risk of crime. If barriers to entry into, and exit from, the gaming industry are low, the marginal operator will earn a normal return. The attractiveness of monopoly profit is removed. Furthermore, with competition it is difficult, if not impossible, for criminal elements to control the industry because new operators can start up. Secondly, the form of gaming would vary. The limited scope for entry into casino and other gaming may encourage large scale operations that are attractive to criminals but which may not otherwise be efficient. It may be instructive to reflect on the way in which the tight control on liquor licences that applied before 1989 led to large booze barns. In a less highly regulated environment, they were replaced by neighbourhood cafes, bars and other classes of outlets. Thus, with competition there are substantially lower incentives for criminals to seek to control gambling and a far lower probability that they could succeed. Is there any evidence to refute the view that organised crime is not a serious threat where a genuinely competitive environment applies? In the United States organised crime is reported to have moved into illegal gaming when the prohibition on liquor sales was lifted;
- some non-gaming businesses operate on a cash basis with a limited audit trail. Certain aspects of banking and most cash-based retailers are examples. Similar risks apply. These risks are reduced by competition and the importance of the firm's reputation to its survival. Moreover, businesses have better incentives to adopt work practices which optimally control risks than regulators. The 1996/97 budget allocation of \$2.3 million for inspections of two casinos (most of which is charged to casino operators), when each casino employs supervisory staff and surveillance equipment, raises questions about the incentives of regulators to impose unduly high costs on operators through industry-specific taxes that are presented as a user-pays policy;
- the community should uphold those values that are critical to a free society, such as respect for the individual and his or her property, and for the rule of law. Fraud and other crime should primarily be deterred by efficient investigation of possible offences and appropriate penalties for those who are found guilty. A careful evaluation of the costs and benefits of any industry-specific measures should be undertaken;
- gaming laws that do not command the general support of the community and which are not appropriately enforced are bad laws. They undermine the integrity of the legal system and its institutions. They encourage otherwise law-abiding citizens to become criminals. There are no circumstances which would justify support for an intentional gap between *de jure* and *de facto* gaming laws; and

- while the risks of fraud and money laundering may warrant consideration in relation to some aspects of gaming, such concerns cannot possibly justify present regulatory arrangements such as the regulation of modest raffles and housie. There is a case for denying people with convictions for offences like fraud the right to operate certain gaming activities. This does not, however, require all casino owners, managers and staff to be licensed. Some people are prohibited from becoming company directors but this provision does not require all company directors to be registered. The practices of other countries should not necessarily be regarded as a useful guide here, unless they are justified on a proper assessment of the relevant costs and benefits.

## 2.5 Protection of the Consumer's Interest

According to the Department:

... much of the present regulatory regime is aimed at ensuring fairness to participants and the integrity of the gaming industry generally. Participants need to know that their chances of winning are fair, that they have as much chance as anyone else, that the prize will be paid out, and that [the prize] is worth what it is said to be worth.

One view is that the inherent nature of gaming, particularly the element of chance, means that participants are at an information disadvantage relative to the gaming operator. This information disadvantage may not be similar to that found in other commercial transactions. Some intervention may be justified to address this concern.

Ensuring fairness to participants appears a legitimate reason for government intervention in gaming. To the extent that it was shown that general legislation was not adequate to address specific concerns in the gaming industry, some gaming industry-specific interventions to ensure fairness to participants should be considered.

The Department's subsequent analysis is of a preliminary nature. In developing it, consideration needs to be given to the following points:

- the most important protection available to consumers in respect of gaming and other activities is provided by low barriers to entry into, and exit from, the industry. This promotes competition, including potential competition, and thereby focuses suppliers on meeting the preferences of consumers at the lowest possible cost. In a competitive environment, suppliers are encouraged to protect their reputation and this provides important safeguards for consumers. The benefits of competition, which is substantially curtailed by existing regulation, were not discussed by the Department;
- present regulatory arrangements disadvantage the consumer. The government has established monopoly or quasi-monopoly rights in many areas of gaming. The resulting rents are shared, in the first instance, between the government (through industry-specific taxes and mandatory contributions) and authorised suppliers. The latter can be expected to incur higher costs and to offer poorer prizes than would be the case if competition were permitted. The rules set for blackjack, for instance, are less favourable to the gambler than those in Australia which are in turn inferior to those in certain areas of the United States. (The level of prizes may, in some cases, reflect a donation to a worthy cause.) To suggest that present regulations advance fairness without examining these issues is a serious omission;

- existing regulatory arrangements may disadvantage the consumer by impeding the adoption of new technology. For example, electronic gaming machines which can be monitored on-line would reduce the scope for tampering and fraud. However, with limits on their location, on the ability to link several machines to a single computer, and on maximum bets and prizes, such machines are unlikely to be economic in many situations. Gaming through the Internet, which is beyond the control of New Zealand authorities and is not subject to inefficient domestic regulation, is likely to increase competitive pressures on domestic providers. The report of the Casino Control Authority for the year ended June 1996 estimates that within 10 years the annual worldwide turnover for Internet gaming will be one trillion dollars. Efforts to regulate this activity are likely to prove futile;
- market responses to an asymmetry of information were not discussed and no arguments were advanced to suggest that information costs are excessive. Other areas of risk and uncertainty, such as life and health insurance, appear to raise larger information problems that are mainly resolved through market mechanisms. In these cases government intervention, beyond the framework that applies to all industries, is limited. Restrictions on advertising may increase information costs faced by consumers. At most, the government may be justified in requiring domestic providers to disclose limited information about their gaming products, perhaps on request or on the ticket or equivalent. However, it is not feasible to regulate in this way gaming that is provided by offshore operators and that is accessed by New Zealand residents;
- the government does not guarantee the solvency of any industry. Prudential supervision of banking focuses on risks to the banking system as a whole. The government has replaced the detailed monitoring of registered banks with a regime that provides for the mandatory disclosure of information to customers on request. There are no better grounds for the government to take on the role of attesting the creditworthiness of providers of gaming than of other producers. Moreover, such a role would expose taxpayers to fiscal risk should a provider fail;
- safeguards provided by the general law need to be carefully examined. While the Department recognises them, it did not identify any possible gaps in the law and whether changes to close them would be justified. Consumer protection law has been substantially expanded during the past decade. The issue of effective application and enforcement of existing laws by the responsible government agencies should also be examined before new protections are proposed; and
- there may be some net benefit from lower transaction costs if the government organises the testing of weights and measures and similar equipment used in the supply of services, including gaming, to the public. This is currently a role of the Ministry of Consumer Affairs. However, any such testing needs to be organised as part of a broader programme and should be contracted out.

## 2.6 Other Grounds for Intervention

The Department is correct in concluding that the promotion of employment, tourism and economic development, which is one purpose of the Casino Control Act 1990, is an inappropriate ground for government intervention. The main reason for this, however, centres on the efficiency with which resources are used rather than the question of fairness among industries.



## 2.7 Conclusion

The grounds for industry-specific intervention in gaming are weak. The heavy regulation of gaming reflects moral and paternalistic views. Most New Zealanders demonstrate by their spending decisions that they believe gaming is an acceptable activity. The risks of crime in a more open and transparent environment are overstated. The welfare of consumers would be advanced by bringing the regulatory regime for gaming into line with that applicable to most other activities.

## 3 REGULATION OF THE SUPPLY OF GAMING

### 3.1 General Controls on the Supply of Gaming

The supply of gaming is highly regulated as the following summary shows:

- the Racing Act 1971 permits betting through the Totalisator Agency Board (TAB) on galloping, harness and greyhound racing, and sports events. The Act confers on the TAB a statutory monopoly on most sports betting, off-course race betting and fixed-odds betting, and an effective monopoly on on-course racing;
- the Gaming and Lotteries Act 1977 permits licensed non-commercial societies to conduct games of chance (for example gaming machines and housie), instant games, prize competitions and lotteries to raise funds for charitable, philanthropic, party political and other community purposes. The Act prohibits bookmaking and largely bans gaming for commercial gain. Licensed promoters are permitted to promote instant games, prize competitions and lotteries, but not games of chance or the use of gaming machines. The promoters act for licensed societies. They may not charge a fee of more than 10 percent of gross proceeds. The New Zealand Lotteries Commission (NZLC), which is established by the Act, has a competitive advantage over other operators of lotteries, prize competitions and instant games because it can pay its distributors (currently at the rate of 7 percent of gross proceeds). Gaming machines are generally restricted to premises licensed under the Sale of Liquor Act 1989;
- the Casino Control Act 1990 provides for the licensing of casinos. Two casinos have been established. The statutory monopoly afforded the Christchurch casino is about to expire while that for the Auckland casino will expire in 1998. This opens the possibility of further casinos being established provided that they are not located within 100 kilometres of the existing casinos;
- there are some limits on the level of prizes that may be offered. Gaming machines, other than those in casinos, have a prize limit of \$500 or \$1,000 for a jackpot. There is no limit on prizes for casino gaming machines or Lotto. Some products such as firearms or liquor are not permitted to be offered as prizes;
- in some cases there are limits on the maximum amount that can be spent on a single bet. The maximum bet on a gaming machine is 20 cents. There is no limit in respect of horse racing;
- the days and hours during which gaming may be supplied are restricted. Housie is the most severely restricted form of gaming. Each licensed society is limited to one three hour session a week between 10 am and 11 pm. Housie is not permitted on Sundays, Christmas day, Good Friday or before 1 pm on Anzac day. Casinos may operate 24 hours a day except on Christmas day, Good Friday and after 3 am and before 1 pm on Anzac day;

- it is illegal for the TAB to extend credit to bettors. A casino operator cannot accept credit wagers without the approval of the Casino Control Authority.

These arrangements are detrimental to the consumer's interest for the following reasons:

- they restrict the supply of gaming to responsible consumers. As argued above, moral and religious objections to gambling, problem gaming and the threat of crime do not justify present restrictions on the availability of gaming;
- they curtail competition and therefore result in higher prices and lower quality services than otherwise, and they impede innovation;
- they alter the pattern of consumption. Gaming options that might otherwise be offered are not available to consumers. The benefits to consumers from technological progress may be diminished. Such interferences with the preferences of consumers impose a cost on them;
- they may require consumers to subject themselves to an ordeal to participate in gaming.<sup>11</sup> This might involve travelling to Auckland or Christchurch to gamble at a casino or travelling to licensed premises to play a gaming machine.

An ordeal is an inefficient method of allocating goods and services among consumers because it results in a waste of resources (for example, an otherwise unnecessary trip). The ordeal is of no benefit to the seller as it does not signal the value of the service that is provided and thus disrupts market equilibration. An ordeal also forces consumers to choose between the product which they wish to acquire and the one which they must give up to do so. Similar constrained choices are not required under price rationing. Finally, the money-equivalent price of the ordeal differs from person to person. (Note the tendency for old people and children rather than people of working age to queue for food in the former Eastern European countries.) For these reasons, ordeals are Pareto-inefficient;<sup>12</sup>

- they distort the pattern of production and distribution. For example, large scale casinos are encouraged. The location of distribution facilities reflects the pattern of trade which emerges under current regulation rather than that which would emerge under an alternative set of rules;
- they distort organisational form. This may lead to higher cost distribution because inappropriate organisational forms, such as not-for-profit firms and government entities, face weaker incentives than other firms;
- they require resources to be committed to the administration of, and compliance with, the regulations. Delays arising from the need to prepare a submission and obtain approval impose further costs on suppliers. In addition, resources are committed to lobbying to obtain favourable rules and outcomes from administrative bodies. Well organised and well-off groups tend to benefit from lobbying at the expense of others. Resources devoted to lobbying are wasted from society's point of view (that is, total output is reduced); and

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<sup>11</sup> A common ordeal is the requirement of some local authorities that hand-held hoses only may be used to water gardens during summer. The ordeal referred to here is additional to that which might otherwise be required (for example a trip to the consumer's preferred outlet).

<sup>12</sup> Pareto efficiency is achieved when it is not possible to make one person better off without reducing the welfare of another.

- they penalise small communities relative to large ones because the former are likely to be serviced by a narrower range of suppliers (for example, casinos).

There are no compelling grounds to continue to:

- license or otherwise restrict the provision of gaming services to the general public. Any class of business should generally be able to provide gaming. Firms should be permitted to decide the forms of gaming they wish to provide and should be permitted to set the level of prizes. Bookmaking would again be lawful as it is in Australia. Issues relating to the location of outlets, noise and nuisance to neighbours are matters that should be addressed under the Resource Management Act 1991;
- control the days and hours of trading. The days and hours of supply of gaming ought to be a matter to be determined by traders (first preference) or made subject to the Shop Trading Hours Repeal Act 1990 (second preference). Since 1 August 1990, most shops have been free to trade 24 hours a day except for Christmas day, Good Friday and Easter Sunday, and up to 1 pm on Anzac day.<sup>13</sup> The establishment of separate rules for selected services, such as the use of gaming machines, would impose unnecessary costs on traders. A common regulatory regime would avoid such costs and could lead to the provision of gaming along with services or goods that are not directly related.

The welfare of consumers would be advanced by bringing the regulatory regime for gaming into line with that applicable to most other activities.

Substantial investments have recently been made under the existing regime. The above changes would therefore adversely affect some private sector suppliers. Statutory protections that have a time limit should generally be honoured, and private firms should be given an opportunity to adjust. It is important, however, that future arrangements are clearly signalled so that they can be taken into account in investment decisions.

### 3.2 Restrictions on Commercial Gain

The two casinos are the only gaming activities that are permitted to be operated for commercial gain. Racing industry profits are required to be applied for the furtherance of that industry. The NZLC is also permitted to pay its distributors. Licensed promoters who operate gaming for community purposes may also be paid but their rate of compensation is limited. Besides these provisions, the net proceeds from gaming are required to be applied for community purposes.

The Department proposes that, subject to any requirement for proceeds to be distributed for community purposes, all forms of gambling should be permitted to be operated for commercial gain. This proposal is supported. The Department's main argument is that the principle was accepted in the casino legislation. Its argument needs to be strengthened. The following points are relevant:

- the pursuit of profit provides the incentive that encourages providers to satisfy the preferences of consumers at the lowest possible cost, promotes innovation, and generates and conveys information that is needed to coordinate demand and supply. When the opportunity to earn a profit is denied or severely restricted, incentives are diminished and consumers suffer through lower quality services, including the absence of services that they value;

<sup>13</sup> These provisions are contained in the Shop Trading Hours Repeal Act 1990 which is administered by the industrial relations service of the Department of Labour.

- the regulation of gaming should be designed to maximise community welfare. This requires a framework that will allow resources to be allocated to their most productive uses. Other than in exceptional circumstances, welfare is enhanced by the incentives provided by the opportunity to earn a profit. The focus on generating revenue to fund unrelated community activities is misplaced for the reasons cited above; and
- the minority view that the pursuit of profit is unethical should be rejected. In competitive markets firms only make profits by supplying goods and services that consumers value. The opposite to a profit is a loss. Sustained losses indicate a waste of resources from the point of view of society.

### 3.3 Advertising and Promotion

There are few industry-specific restrictions on the advertising of gaming. The Casino Control Authority has reserved the right to require the tone of advertising by casino operators to be changed if it is considered to be in bad taste. The Department states that the advertising of gaming machines would not be considered a legitimate operating expense, but it does not explain its reason. It notes that one objective of regulating gaming would be to ensure that operators abide by any specific requirements relating (among other things) to the level of advertising. These issues raise the general question of whether there are valid grounds to control the advertising of gaming activities.

Industry-specific controls on the advertising of gaming might be advocated because advertising encourages consumption that is harmful to society, including that by vulnerable members of society such as young people and problem gamblers. An economic perspective of advertising provides a contrary view. This is outlined below:

- advertising is associated with freedom of speech, a right which is fundamental to the freedom and dignity of members of a free society. The preservation of freedom of speech, subject to some limits, is normally seen as a key function of democratic governments.<sup>14</sup> Potter *et al.* (1994) accepted legal advice that a ban on liquor advertising and sponsorship could breach the New Zealand Bill of Rights Act 1990. Any prohibition of the advertising of gaming could also breach the Act. The extent to which less restrictive controls on advertising might be inconsistent with the Act is unknown;
- advertising reduces the cost to consumers of identifying sellers, obtaining information on alternative products and other goods and services that are available, and on their relative prices. Because advertising facilitates competition, it also generally results in lower quality-adjusted prices.<sup>15</sup> These benefits of advertising enhance the welfare of consumers;
- there are no compelling grounds for believing that advertising can have a large impact on aggregate consumption of gaming or other products because relative prices and income largely explain demand.<sup>16</sup> Advertising expenditures are generally believed to have a limited impact on aggregate demand and a more significant impact on the distribution of sales among competitors;
- if a reduction in the price of products were worth more to consumers than advertising expenditure, consumers would voluntarily demand less advertising and lower-priced brands, and producers would also exploit this opportunity.

<sup>14</sup> Okun (1975) and Gray (1992).

<sup>15</sup> See, for example, research reviewed by Pauly (1986) relating to restrictions on the advertising of medical services and supplies.

<sup>16</sup> See Smart (1988) for a review of empirical evidence in respect of the advertising of liquor.

(The supply of 'no frills' products in supermarkets is a partial example of this response.<sup>17</sup>) This proposition illustrates the point that advertising conveys information relating to the quality of products – for instance information on the reliability of the product, such as the odds offered – and does not just reduce search costs;<sup>18</sup>

- controls on advertising reduce the marginal efficiency of advertising expenditure and thereby impose a deadweight cost on the community. Restrictions on the style of advertising (over and above valid ones that apply to all industries on matters such as misleading or deceptive advertising), the medium which may be used and the time at which advertisements may be broadcast also impose deadweight losses for similar reasons;
- brand advertising promotes the reputation of producers and distributors. They have incentives to enhance their reputations and their long-term interests are damaged by the association of their products with misuse such as pathological gambling. To the extent that restrictions on advertising inhibit the promotion of the reputations of producers and distributors, they impair the incentive to discourage the misuse of their products; and
- advertising bans, by lowering the non-quality-adjusted price of the product, may increase consumption of the product concerned by a small amount, thereby biasing consumer choice. In addition, bans may prohibit the promotion of responsible gaming, thereby contributing to higher demand than otherwise for less desirable forms.

Private individuals and groups who wish to promote lawfully the prohibition of gaming or its moderate use should be able to do so using their own resources. As Gray (1992) concluded:

The danger [to society] comes, not from advocacy advertising, but from restrictions on advertising which have the same goals as some of the advocacy groups ... who pursue these goals via restrictive regulation and prohibition rather than by persuasive communications.

The above reasons suggest that a sceptical view should be taken of industry-specific restrictions on advertising. The same view applies to any self-regulation that is motivated in large part by the desire to avoid statutory regulation. The evidence indicates that such restrictions harm consumers. Controls on advertising restrict the availability of gaming and do not address abuse. They cannot be justified on economic grounds and should be excluded from any regime for gaming.

#### 4 THE MINIMUM AGE FOR GAMING

The present minimum ages for gaming range from 16 for Instant Kiwi, 18 for betting on horse and greyhound races, and 20 for entry into a casino. The question of whether there should be restrictions on the age at which people may engage in gaming and, if so, the broad nature of such limits, needs to be examined. The Department raises this issue but does not discuss the principles involved or put forward a proposal.

<sup>17</sup> The reputation of the distributor rather than that of the producer is emphasised with no frills products. The limited size of the no frills market relative to that for comparable branded products illustrates the importance to consumers of advertising and similar expenditure.

<sup>18</sup> Schneider, Klein and Murphy (1981) and Barzel (1982).

An economic approach to these questions starts from the proposition that, unless special factors apply, gaming should be treated like most other goods and services for regulatory and taxation purposes. Its consumption is a matter for individual choice and responsibility. The next step is to examine whether there are valid grounds for specific government intervention. The costs and benefits of any intervention would then need to be assessed.

Society accepts that individuals generally make rational choices - not in the sense that they do not make mistakes but that they do not systematically repeat them and act against their interests. Except for a few products that are prohibited from sale or distribution, such as illicit drugs, or those that are sold subject to special conditions like firearms, traders are entitled to supply goods and services, and adults of sound mind are able to choose whether to buy them.

Young people, because of their immaturity and limited experience and knowledge, may not always be able to make rational and informed decisions. This, for example, is the economic rationale for limits on the capacity of minors to enter into enforceable contracts. Under the Minors' Contracts Act 1969, contracts, except those of life insurance or of service, made by persons under the age of 18 years are prima facie not enforceable against the minor.<sup>19</sup> In the absence of a minimum age for gaming, providers are likely to exercise care in deciding whether to supply young people, especially in relation to the supply of credit, as such a contract would be unenforceable against a minor.

Parents (and other people who act in their place such as guardians) can be expected to oversee the decisions of their children. Parents are generally assumed to act in the best interests of young people because they have stronger incentives to do so than any other person or agency.<sup>20</sup> For this reason, the rights of parents to act for children should generally be upheld and interventions should be restricted to clear cases of negligent or abusive behaviour.

The prime responsibility for overseeing gaming by young people rests with their parents. On this basis the supply of gaming services to children would be not be prohibited where the relevant parent (or guardian) explicitly authorised his or her child's actions (for example, when the parent is present). This approach would imply a reduction in the restrictions that apply at present. A person under 16 years of age that is accompanied by an adult cannot lawfully buy Instant Kiwi. The suggested approach would, for instance, imply that there should not be a general age limit on participation in gaming by children who are with a parent.

Parents are unlikely to face greater costs in constraining participation in gaming by young people who are under their care and in monitoring their behaviour in this regard than in respect of most other activities. In relation to gaming, the consequences of children acting in a way that is inconsistent with the wishes of their parents do not seem to be particularly costly. Unlike the consumption of tobacco and liquor, there is no direct risk to their health or accidental injuries to third parties, respectively, with gaming.

If parents faced excessive costs in constraining the activities of children, government regulation of the minimum age for gaming may be justified. It would be necessary for the government to satisfy itself that the benefits of bringing young people's pattern of

<sup>19</sup> The court is empowered to enquire into the fairness and reasonableness of the contract at the time it was entered into and, if satisfied that it was fair and reasonable, may enforce it against the minor, declare it binding on him or her in whole or part, make an order entitling other parties on such conditions as the court thinks fit, to cancel the contract, and make an order as to compensation or restitution of property.

<sup>20</sup> Becker 1991.

gaming closer to that approved by their parents outweigh the costs involved. The latter include administration and compliance costs, and interference with the freedom of those parents whose preferences would be unable to be met.

If this approach were adopted, a minimum age at which the consent of parents would not be required to participate in gaming would need to be set. This relates to the age at which young people are generally considered to be sufficiently mature to judge their long-term welfare and the willingness of the community to enforce a particular age limit. For a range of activity, the former is generally between 16 years (for a full driver's licence and to appear before the District Court) and 18 years (for the right to make a will, to enter into an enforceable credit contract without parental consent, to obtain a firearm's licence, to vote in a general election, to undertake jury service, to serve in the defence forces and to go to war). While 16 years is the minimum age at which a person can be married, people under the age of 20 generally require their parent's consent. The school leaving age is to be set at 17 years. The present minimum drinking age is generally 20 years, but in some circumstances it is 18 years.

There seems little justification for a higher minimum age for casinos than for other forms of gaming. The minimum age for entry into a casino in Queensland is 18 years.

The key conclusions which emerge from the above discussion are that:

- public policy grounds for setting an explicit minimum age for all gaming are doubtful; and
- if a minimum age at which young people can participate in gambling without parental consent is to be set, it should be between 16 and 18 years. There should be no minimum age where young people participate in gaming with the consent of a parent.

## 5 GAMING DUTIES AND THE FUNDING OF COMMUNITY ACTIVITIES

The Department states that:

The community distribution reason for government intervention is a long standing historical tradition in New Zealand and also has parallels with gaming policies in overseas jurisdictions. Community groups provide the infrastructure necessary to enable the government to work in partnership with local communities in areas such as crime prevention. In this sense funding for these groups can be seen as an instrument contributing to the major government objective of promoting social cohesion and building stronger communities. ...

Contribution to community purposes is also widely supported as a reason for government intervention by the public. For many it is seen as a means of compensating for the social cost of gambling.

While the Department summarised some arguments for the contrary position, it concluded:

There should be a requirement for all forms of gaming to contribute to community purposes in an appropriate and equitable manner.

The Department did not examine the key issues involved which are as follows:

- the public policy grounds for the imposition of industry-specific taxes; and
- the merits of tied funding for community activities.

Nor did the Department discuss the level of funding that is appropriate and equitable. The efficiency of related spending should also be examined critically before any commitment is made to continue tied taxes. This aspect is not examined further.

The TAB and operators of gaming machines are subject to gaming duty at the rate of 20 percent of gross profit. The NZLC and casino operators pay 5.5 and 4.0 percent respectively of their turnover. Gaming duty is expected to yield about \$126 million in 1996/97.

The net profits from gaming machines and lotteries are required to be distributed for community purposes. The profits from the TAB are required to be applied for the advancement of the racing industry. Casino operators have been expected to contribute funds to community purposes over and above the 4 percent duty they pay, and it is understood that the TAB has similarly made voluntary contributions.

### 5.1 Industry-specific Taxes as Substitutes for User Charges

A possible argument for imposing industry-specific taxes is to fund related health costs. The costs of subsidised health services that are provided in response to gaming-induced illnesses fall on taxpayers rather than the people concerned. The policy of not charging users for the full cost of health services reduces the incentive for people to adopt healthy lifestyles (for example, to exercise and to eat a balanced diet) and encourages them to engage in risky pursuits.<sup>21</sup> This problem relates to many activities (for example, risky non-professional sports and recreational activities, such as aviation sports, rugby football, motor racing, mountaineering and diving, as well as to illegal activities such as participation in crimes).

The financing of most health services through the tax system means that the health costs incurred by participants in gaming result in higher taxes on other taxpayers. The best solution to this problem is to charge most users for the health services which they consume (with a commensurate reduction in taxation and an increase in private insurance arrangements). The funding of certain health costs through the Accident Rehabilitation and Compensation Insurance Corporation is a tentative step in this direction. There would be equity grounds for the government to provide a modest level of services on a targeted basis or to require compulsory insurance at a prescribed minimum level (if the free-rider problem would otherwise be excessive).<sup>22</sup> This would substantially shift the costs of health care to individuals and thereby encourage them to make optimal decisions on the consumption of gaming and on other matters which affect their need for health services. Taxes impose deadweight costs (output losses) whereas appropriate user charges do not. This arises because all practical taxes alter the choices facing taxpayers. An income tax, for example, discourages work, saving and investment.

<sup>21</sup> User charges are also a more efficient method of allocating resources. User charges for health services would result in a demand for insurance. Provided that there are no policy-induced impediments which prevent premiums from reflecting the risk characteristics of the insured (for example appropriate experience rating), such policies would be consistent with the provision of incentives for healthy lifestyles.

<sup>22</sup> A free-rider problem arises if people expect the government to provide services free of charge. This would diminish the incentive to buy insurance. If the problem is sufficiently large it may be desirable to make insurance at some minimum level compulsory.



If the government is not prepared to charge for most publicly provided health services for equity reasons, then the question arises whether it is efficient and equitable to impose specific taxes on gaming to fund related health costs. The merits of such taxes are doubtful for the following reasons:

- the health risk from gaming is very low for most people. Excessive costs would be placed on people who are unlikely to impose additional costs on taxpayers while insufficient costs would be borne by participants who are most at risk. It is doubtful that this would produce a net benefit;
- gaming is only one activity that may lead to higher health costs. Others include participation in certain sports and recreational pursuits, and criminal activities. There is no valid basis for singling out one particular activity as the degree of risk varies considerably;
- one effect of singling out certain activities, such as gaming and the consumption of liquor and tobacco, is to encourage substitution between them and other hazardous activities. The effect of excise taxes would not be limited to a reduction in gaming and an increase in low risk activities;
- to be an efficient taxing (charging) instrument, the incremental tax on each dollar spent on gaming should equal the related marginal health care cost. The form and quantity of gaming should be taken into account. The averaging of the total cost of health care provided for problem gamblers in a given year over all gaming falls well short of this standard. In particular, low to moderate consumers should, at most, face little or no tax;
- we are unaware of any estimate of the amount of health costs that is involved. It would be most surprising if it were anywhere near the present level of duties and mandatory community contributions; and
- if industry-specific taxes are imposed for health reasons they should be directly related to the costs imposed on society by gaming and not used to finance other activities. Only a small amount of the funding provided by gaming is allocated to address social costs directly attributable to gambling. The vast majority of funding goes to unrelated activities such as subsidising films and other cultural pursuits, and sporting activities.

If the government chooses to provide subsidised health care for equity reasons, the adverse efficiency implications of that decision are unlikely to be lessened by applying specific taxes to gaming. It is more likely that moral rather than economic arguments account for industry-specific taxes on gambling.

## 5.2 Revenue Taxes

A further question is whether gambling is an appropriate tax base for general revenue purposes. Moralistic and paternalistic arguments have been advanced for discouraging gambling by imposing taxes. Any moral or religious objections to gaming are not overcome by applying part of the proceeds to causes that are deemed to be worthy. The ends do not justify the means.

The key economic argument advanced for industry-specific taxes on gaming is simply that they are accepted by the public. A 1995 survey found overwhelming (94 percent) support for taxing gaming to fund worthy causes but much lower support (25 percent) for its use to raise general government revenue.<sup>23</sup> There are, however, substantive reasons for doubting the efficacy of gaming as a general tax base:

<sup>23</sup> Reid and Searle (1996).

- broad-based low-rate taxes have been adopted in New Zealand because they are judged to impose the lowest efficiency cost. The information required to apply variable taxes consistent with the findings from optimal tax models is not available to policymakers. Variable taxes encourage lobbying that may lead to an erosion of the tax base over time. For these reasons, public policy experts have generally supported the adoption of broad-based low-rate taxes.

According to research reported in an economic impact study, gaming is a price elastic activity.<sup>24</sup> This suggests that gaming is not a suitable base for general revenue purposes because it would impose relatively high deadweight costs for every dollar of revenue raised;

- industry-specific taxes reduce the international competitiveness of domestic suppliers. Gaming is, at the margin, a tradeable activity. People can engage in offshore gaming through the Internet and in other ways. Domestic suppliers are therefore disadvantaged compared with offshore operators which are not subject to domestic taxes. Residents may also be encouraged to travel overseas to participate in gaming. In addition, inbound tourists may be sensitive to the cost of gaming in different jurisdictions. Such tourists are discouraged by industry-specific taxes unless non-residents are exempt. This is not the case;
- taxes on gaming breach the principles of horizontal and vertical equity. Gamblers pay higher taxes than non-gamblers who earn the same total income, and non-gamblers on high incomes may pay less total tax than gamblers on lower incomes. To the extent that such taxes are levied on low income groups and used to fund activities that mainly benefit people on high incomes, such as ballet and opera, they are regressive; and
- industry-specific taxes on gaming are likely to impose high compliance and administration costs. Suppliers need to be registered and gaming activities need to be defined and identified. New opportunities are likely to be devised to minimise or avoid the tax. Technological advances are likely to increase avoidance opportunities over time.

Recent tax reforms have removed or reduced the most distortionary taxes. Gaming duty and compulsory funding of community activities from gaming have not been addressed. GST and income tax (where gaming is undertaken for profit) alone should apply to gaming.

### 5.3 Tied Spending

Tied funding of public activities is generally undesirable because such expenditure is not subject to appropriate scrutiny and is not evaluated against competing claims. If resources are committed to activities that yield a lower return to the community than could be obtained elsewhere in the public sector or in the private sector, community welfare is reduced.

This criticism is particularly relevant to spending funded from gambling. There appears to be limited opportunity for a regular first principles review of the \$190 million that is distributed for community activities under the Gaming and Lotteries Act 1977. The Department reports that little information is available on the disposition of the proceeds from gaming machines. It is uncertain whether all funds are transferred to genuine charities, and some charities benefit people on high incomes. There are grounds for questioning the social benefits of such expenditure.

<sup>24</sup> Coopers & Lybrand (1996).

Furthermore, the analysis presented below suggests that the existing lottery system channels large sums to administrators and Crown entities rather than the community groups which are the intended beneficiaries.

The NZLC's operating costs amounted to 14.6 percent of sales in 1995/96 (see table 1). The allocation of costs among categories appears to have been fairly constant over recent years. The TAB has a similar sized network, larger turnover and a more complex product range than the NZLC. The TAB's operating costs were 7.7 percent in 1994/95. (This percentage has been fairly constant in recent years.) If the TAB's operating costs are adjusted to encompass the same proportion of expenditure on advertising as the NZLC (which may not be efficient), they rise to 9.3 percent of sales, which is still well below that of the NZLC.

**TABLE 1: NZLC Costs of Operation 1995/96**

<i>Category</i>	<i>Cost \$m</i>	<i>Cost: Sales %</i>
Franchised retailers commission	43.8	7.0
Ticket costs	4.3	0.7
Advertising etc.	20.6	3.3
Other operating expenses	22.5	3.6
<b>Total costs of operation</b>	<b>91.2</b>	<b>14.6</b>

A further indication that the NZLC is a high cost operator is provided by overseas experience. Many overseas lotteries (including the United Kingdom's massive new lottery) are operated by private firms. It is understood that they typically charge about 4 percent of turnover.<sup>25</sup> Although their costs may not be comparable with those of the NZLC, there seems to be scope for substantial efficiency gains. These can best be realised by permitting private operators to provide lotteries. New technology is likely to facilitate competition, particularly for lotteries. Continuing inefficiencies by the NZLC will lead to a loss of business to overseas suppliers.

In 1995/96 the administration expenses of the Lottery Grants Board (LGB) accounted for 5.2 percent of its income (see table 2). This appears to be significantly higher than the ratios of 1.4 percent in 1989/90 and 1.6 percent in 1990/91, recorded when additional income from lottery reforms became available. The levels of administration cost appear all the more remarkable given that:

- around 40 percent of income is allocated in bulk to the Hillary Commission, Creative New Zealand and the New Zealand Film Commission (NZFC) on a percentage basis which is set by the government. The LGB incurs minimal administrative costs in distributing these funds. LGB administrative costs accounted for 8.7 percent of the remaining sum in 1995/96;

<sup>25</sup> *Fortune*, November 11, 1996 and information provided on the internet by La Fleurs (<http://www.lafleurs.com>). La Fleurs is a major provider of information to lottery operators.

**TABLE 2: Operating Costs as a Percentage of Turnover or Receipts**

<i>Lotteries Commission</i>		%	5-year range (%)
Direct operating costs	1996:	6.9	6.7 – 7.0
Other costs of lotteries	1996:	7.6	7.6 – 7.9
Total	1996:	14.6	14.5 – 14.9
<i>Lotteries redistributive bodies</i>			
Lotteries Grants Board	1996:	5.2	2.7 – 5.3
Lotteries Grants Board adjusted <sup>1</sup>	1996:	8.8	3.7 – 8.9
Hillary Commission	1996:	7.2	7.4 – 14.0
Creative NZ/QEII Arts Council	1996:	21.7	16.8 – 22.7 <sup>2</sup>
NZ Film Commission	1996:	8.8	5.2 – 9.6
TAB	1995:	7.7	7.3 – 7.9

<sup>1</sup> Adjusted for distributions to the Hillary Commission, Creative NZ/QEII Arts Council and the NZFC.

<sup>2</sup> Based on operating costs reported in their annual reports. There appear to have been several changes in accounting policy. Operating costs (including touring programmes, advocacy and communications, and Pacific Island committees) may have reached some 25 percent in 1993 but fell to 21.7 percent by 1996.

- the LGB automatically receives its income from the NZLC. Thus, little work is required to raise its income; and
- staffing and support services are provided (at cost) by the Department. Unlike many small organisations, the LGB does not seem to face dis-economies of scale.

Given these factors, and technological advances, it is hard to see why the LGB's functions should cost more than they did in 1989/90 – at 1.4 percent of income or almost \$5 million less than they cost in 1996.

The LGB also has a tendency to award funds to large organisations or Crown entities. In 1994/95 some \$7 million (5.6 percent) of its allocations went to Lottery Health and Science Research Committees which awarded funds almost entirely to universities, CRIs and other Crown entities. The minister of internal affairs's discretionary fund made the majority of its grants to the National Museum. The projects concerned may be worthy, but such allocations do not appear to reflect the reported goal of the LGB which is "to support and encourage self reliance in New Zealand communities".

In 1994/95 the government provided over \$280 million (for 1996/97 over \$300m) for public good science and technology through Vote: Research, Science and Technology. It is difficult to envisage the need for a top-up through the LGB. The LGB committees are unlikely to be better equipped to assess public good projects than the Foundation for Research, Science and Technology.

The three bodies that are bulk funded by the LGB also impose high costs on the distribution process. The Hillary Commission received some 32 percent of its income from the LGB in 1995. Its corporate services cost some 7.4 percent of income in 1995 –

a considerable reduction on the early 1990s (such costs peaked at 16.7 percent in 1990), but apparently high for a body whose main function is to act as a conduit for funds. Creative New Zealand received some 82 percent of its funds from the LGB in 1996. Its operating costs amounted to a remarkable 21.7 percent of such funding. (An examination of its accounts suggests that this is a reduction from the equivalent of 24 to 25 percent in 1993 and 1994.) The NZFC received some 59 percent of its funds from the LGB in 1995. Its operating costs were 8.8 percent, an increase from the 5 to 7 percent recorded in the early 1990s, though there has been some reallocation of expenses, and the NZFC has engaged in the marketing of New Zealand films overseas (from which it has gained significant income).

The allocation of large amounts through the LGB to the bulk-funded bodies means that the accountability of those organisations is weak. The government appears to have less influence in the areas concerned (cultural affairs and sport) than might be expected given the level of funding provided to these organisations. In 1994/95 grants from Vote: Cultural Affairs for the promotion and support of the arts were only 21 percent of the size of LGB grants to Creative New Zealand, and grants for the promotion and support of New Zealand films were 12.8 percent of LGB grants to the NZFC. Grants from Vote: Sport, Fitness and Leisure to the Hillary Commission and other bodies were only 2.3 percent of LGB grants to the Hillary Commission.

Overall, the distribution of lotteries funding appears to be characterised by excessive administration costs and possible mis-direction to non-community based groups. Some \$16m of additional funds annually (about a 14 percent increase) could be made available to the community if these issues were addressed.<sup>26</sup>

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This would be achieved by reducing the LGB's administration costs to previous levels and that of the three bulk-funded bodies to 5 percent and reallocating the funds given to non-community based bodies.

**TABLE 3: Lotteries Costs**

The breakdown of every \$100 bet on Lotteries Commission products is approximately as follows:

	\$	\$
Prizes	55.80	
<b><i>Sub-total; prizes</i></b>		<b>55.80</b>
GST	4.90	
Lottery Duty	5.50	
<b><i>Sub-total; indirect taxes</i></b>		<b>10.40</b>
Commission for retailers	7.00	
Cost of tickets	0.80	
Operating expenses of Lotteries Commission	7.00	
<b><i>Sub-total; lottery operations</i></b>		<b>14.80</b>
Lottery Board operating costs	0.94	
Operating costs of Hillary Commission, Creative NZ and NZFC	1.06	
<b><i>Sub-total; distribution costs</i></b>		<b>2.00</b>
<b><i>Sub-total; all operating costs</i></b>		<b>(16.80)</b>
Distributed to large Crown Entities	1.00	
Distributed to community groups	16.00	
<b><i>Sub-total; distributed</i></b>		<b>17.00</b>
<b><i>Total:</i></b>		<b>100.00</b>

The LGB model is an extremely poor one. Funding of community organisations should be through the relevant Votes to ensure accountability both in respect of those organisations and of the government departments charged with policy in the relevant areas.

Any allocation of funds to community bodies should be decided through the budgetary process or bodies that are accountable to the community. Unaccountable monopolies are to be avoided. Funding should be restricted to genuine community bodies and not central Crown entities.

The high administration costs of the LGB and the bulk-funded bodies, and the direction of funds to large or Crown entities, mean that community-based bodies receive less than half the after-tax funds available from lotteries (see table 3). This is undesirable.

## 6 GOVERNMENT OWNERSHIP

Government-owned or controlled entities are major suppliers of gaming services. They include:

- the NZLC, the task of which is to promote, organise and conduct all New Zealand lotteries defined in the Gaming and Lotteries Act 1977, such as Lotto, Instant Kiwi and Daily Keno. The NZLC has a competitive advantage over other suppliers of lotteries, prize competitions and instant games because it is

able to pay its distributors. It also benefits from an implicit government guarantee. The NZLC operates as a business. The Secretary for Internal Affairs is a member of the NZLC; and

- the TAB, which has a statutory monopoly on most sports betting, off-course race betting and fixed-odds betting, and an effective monopoly over on-course race betting. All profits are applied for the furtherance of the racing industry. The TAB is a Crown entity. The minister for racing appoints members of the TAB.

The key question that arises is whether government entities should continue to supply gaming services. The Department did not examine this issue on a first principles basis. Its paper assumes that the government may wish to operate gaming to raise funds for community purposes and notes that, in this event, there should be a segregation of the government's roles as regulator, operator and distributor of funds.

We submit that the government should cease to operate gaming for the following reasons:

- the provision of gaming extends well beyond the proper role of the government. There are no special features of gaming that justify public ownership. Gaming is a private activity. Present monopoly problems do not result from the nature of the gaming market but are created by poorly conceived regulation. Concerns about problem gaming do not justify public ownership. In its examination of the liquor industry the Laking working party found that public sector providers could not claim a better record in addressing problem drinking than their private sector counterparts.<sup>27</sup> The same finding could be expected in the case of problem gaming because private firms face stronger incentives to protect the long-term success of their business;
- public ownership, particularly when coupled with other impediments to competition, leads to inefficiency. The residual owners of public enterprises have little stake in the firm. They therefore have fewer incentives to monitor management than owners of private firms. This leads to excessive costs and a divergence between the interests of the owners and those of other interested parties. The lack of competition weakens cost control, reduces choice for consumers and impedes innovation. The corporatisation and privatisation process in New Zealand and elsewhere has shown that these costs are often substantial.

Public enterprises that are not subject to market disciplines, including the requirement to earn an appropriate return on capital, inhibit fair competition by driving from the market businesses that would otherwise be successful. They create a less predictable environment. Public ownership leads to political interference in commercial matters and encourages lobbying by interest groups which is a waste of resources from a community perspective;

- public ownership of businesses conflicts with taxpayers' preferences for personal spending and saving, and for risk taking. Instead of investing in commercial assets the government could retire debt and then reduce taxes. Debt retirement is broadly equivalent to a reduction in future taxes because projected interest costs and principal repayments are lower than otherwise. Lower taxes would leave taxpayers more scope to satisfy their preferences for personal spending or saving.

The preferences of taxpayers are unlikely to be uniform because they face vastly different circumstances. Some taxpayers may be hard pressed to pay for

<sup>27</sup> Laking *et al.* (1986).

necessities such as food, housing and clothing. They could be expected to put a low priority on the retention of non-core assets by the government compared with a cut in taxes which would increase their disposable incomes. Taxpayers who wish to invest in commercial assets can do so independently of the government. The government cannot reflect the preferences of each taxpayer since its decisions affect all taxpayers.

A similar point arises with regard to risk taking. The willingness of taxpayers to take financial risks differs. The government should pursue low risk strategies because of the weak incentives that politicians face and because taxpayers are compelled to bear the risks that are incurred. The sale or disposal of non-core assets reduces the risk that taxpayers bear.

Most taxpayers have limited opportunity to influence the government's decisions, and they have few options to offset the effect on them of bad decisions. It is very costly, for example, to move to another country with a more satisfactory taxing and spending policy. For these reasons, governments should limit the scope and extent of their activities;

- public ownership of gaming operations leads to spending on low priority activities. There is a high probability that the proceeds are used to fund projects that the government would not be prepared to raise general taxes to finance. Income is likely to be spent on relatively low priority projects in response to political pressures. Community welfare is reduced when the public sector uses resources that would yield a higher return in the private sector;
- public ownership of gaming activities diverts the government's attention from its prime task of undertaking its core functions efficiently; and
- proper financing of community activities would make their costs more transparent to taxpayers. The government should not try to conceal the true burden of such activities.

The main options available to the government in respect of the NZLC are to:

- privatise its business after putting in place an appropriate regulatory regime for gaming. This approach would have the advantage of eliminating future risk to taxpayers and of capturing the value of the business for the present owners (that is, the taxpayers). This is the preferred option;
- establish a community trust to assume ownership of the business. The argument for this approach might be that community organisations have been the main beneficiaries of the business. They would be given the right to operate it but in competition with other providers. This option follows the trustee bank model and might reduce any opposition from affected interests; or
- tender the rights to provide gambling services of the type provided by the NZLC. This would introduce competition into the operation of its business, but taxpayers would continue to be the residual risk holders (assuming it was successful in winning tenders). The NZLC should be constrained from entering into new areas of operation and thus increasing the risks borne by taxpayers.

The key options available to the government in respect of the TAB are to:

- gift ownership of the TAB to the racing industry after removing its statutory privileges. The profits of the TAB are currently applied for the benefit of the racing industry; or



- privatise it by open sale. This would capture its value for taxpayers. It may, however, be argued that the Crown is not entitled to claim the ownership interest in the TAB's business. It is understood that the Victorian government has recently privatised the TAB's counterpart in that state.

## **7 THE DEPARTMENT OF INTERNAL AFFAIR'S POLICY PROPOSALS**

Brief comments are presented below on the Department's policy proposals. The arguments advanced above are not repeated. The following comments should therefore be read in conjunction with the foregoing discussion.

### **7.1 Should There be a Single Policy Framework?**

The thrust of the proposal that there should be a single comprehensive policy framework for the gaming industry is supported by this submission, provided that it is not intended to apply a uniform approach to all forms of gaming without taking into account costs and benefits. It would, for example, be inappropriate to license modest raffles if it were decided that casinos should be licensed to address the risk from organised crime.

The framework should encompass taxation and ownership issues as well as industry regulation. A framework that does not address all major aspects of government intervention in the industry cannot be said to be comprehensive. As the Department notes, technological change is likely to blur the distinctions between different forms of gaming and make existing regulatory regimes obsolete. Three points are emphasised with respect to technology:

- the more prescriptive a regulatory regime and the less responsive and efficient its management, the more rapidly it will become outmoded;
- technology is exposing gaming to international competition. Inappropriate or inefficient regulation, ownership or taxation of gaming in New Zealand will lead to a loss of business to international suppliers. This impact will differ according to the form of gaming; and
- the blurring of boundaries is not only between different forms of gambling but between the geographical location of the operator and the gambler, and between gaming and non-gaming activities. This makes gaming more difficult to regulate extensively on a national basis.

### **7.2 Proposed Principles**

The Department proposes that the policy and framework for gaming should be governed by the following overarching principles:

- comparability of treatment and regulatory neutrality both within the industry and between operators;
- consistency and predictability;
- transparency of operation;

- least cost intervention such that net benefits to the community are maximised; and
- consistency with the Treaty of Waitangi.

The overarching principle should be the promotion of community welfare, and it follows that the key criterion for judging policy options should be the efficiency with which economic resources are used by the industry. This criterion is largely absent from the Department's paper. While neutrality of treatment is desirable in many instances it is not an overriding principle. The promotion of efficiency would, for example, require closely substitutable forms of gaming to be treated on a neutral basis, but it would not necessarily justify the same treatment for other gaming activities. The Department appears to place too much weight on neutrality rather than on an appropriate assessment of the costs and benefits of particular proposals.

Subject to these observations, the principles of consistency, predictability, transparency and least cost intervention are appropriate. We doubt the relevance of the Treaty of Waitangi in this context.

The economic impact study attempts to compare the merits of different regulatory regimes for gaming.<sup>28</sup> However, as the authors note, a comparative static approach is taken. This fails to capture dynamic and other efficiency effects of different regulatory regimes. Most of the issues raised above were omitted from the study.

### **7.3 Reasons for Government Intervention?**

The Department's proposals were discussed above. A more rigorous approach than that taken by the Department, consistent with those applied in comparable areas of public policy, is required.

### **7.4 What Mechanisms Should be Used for any Profit Distribution for Community Purposes?**

The Department suggests that there should be an integrated national distribution regime designed in consultation with interested parties. This is predicated on the view that gaming should be taxed to fund a wide range of community activities. For the reasons discussed above the NZBR does not agree with that view.

The Department's proposal appears to constitute an enlargement of the LGB's functions and associated distribution mechanisms. As discussed, a centralised system, operating outside the government's budget process and financial management system, would lead to poor accountability and invite inefficiency and lobbying. The existing lottery system demonstrates these risks, and channels large sums to administrators and to Crown entities rather than to community groups, which are the intended beneficiaries.

### **7.5 Who Should be able to Operate Gaming?**

The Department proposes that:

- entry into the gaming industry should be governed by some form of entry test (to be determined) designed to ensure the integrity of the operator, and to meet the government's objectives including the prevention of crime and fraud;
- as a general rule, all forms of gaming should be open to all operators subject to meeting the test described above; and

<sup>28</sup> Coopers & Lybrand (1996).

- the entry test should be as consistent as possible across all sectors, and should be transparent and reflect a least cost approach.

These proposals are based on the Department's view that the government should intervene to ensure fairness to participants and to prevent fraud and crime. We argue that less restrictive entry requirements would better promote the interests of the consumer. As discussed above, the arguments advanced by the Department do not justify the licensing of gaming operators. At most, some limited restrictions on the right to supply gaming services may be justified but these would not require licensing. Moreover, the risks of crime are not the same for all forms of gaming. The application of a uniform test does not take account of relative costs and benefits. Resources committed to vetting applications to operate small-scale house evenings and raffles would be more profitably employed elsewhere.

### **7.6 To What Extent Should Gaming be Regulated?**

The Department has not put forward specific policy proposals in this area. Its conclusion that generic regulatory frameworks, such as the Fair Trading Act 1986, should be relied upon to the maximum extent possible is endorsed. On the other hand, it appears that the Department has not ruled out regulating the time of play, the location of gaming operations, the level of prizes and the provision of credit. These matters are controlled at present.

The grounds for industry-specific controls along such lines are dubious. Restrictions on trading days and hours of gaming are aimed at limiting the supply of gaming rather than at problem gambling. This approach has been rejected in relation to the sale of liquor. The level of prizes should be set by gaming suppliers who will respond to competition. The provision of credit should also be a matter for suppliers. It is implausible to believe that a prohibition on the supply of credit by gaming operators would produce significant benefits. Alternative sources of credit are readily available to creditworthy people.

### **7.7 How Should any Regulation be Applied?**

The broad thrust of the Department's proposals is supported by this submission. Where feasible, the cost of regulation should be borne by the relevant beneficiaries. This proposition generally implies user charges. However, the cost of unjustified regulation should not be imposed on the gaming industry and inefficient government agencies should not be able to pass on their costs. Where feasible, regulatory activities should be contracted out to enhance efficiency.

### **7.8 What Taxation Regime Should Apply to Gaming?**

The view that gaming should be subject to the same taxation regimes that apply to other industries is endorsed. As discussed above, we do not believe that industry-specific taxes could be justified on valid public policy grounds. Gaming duty and compulsory community contributions constitute such taxes.

### **7.9 What Should be the Government's Role in Gaming?**

The Department suggests that the government's role is to:

- determine policy and the regulatory and taxation regime to apply to gaming;
- enforce the regulatory regime; and
- organise research into gaming and provide public information.

It suggests that the government may also wish to operate gaming to raise funds for community purposes.

The determination of policy and the establishment and enforcement of a regulatory framework are normal governmental functions. The extent to which research needs to be undertaken (aside from funding from the public good science pool and other sources) and information generated and provided to the public would be substantially reduced if the proposals contained in this submission are adopted. Competitive markets are a powerful mechanism for the discovery and dissemination of information.

The Department did not critically review whether the government should engage in the provision of gaming. As noted above, a valid case could not be made for this role.

## 8 CONCLUSIONS AND RECOMMENDATIONS

The thrust of this submission is that the regulatory framework for the supply and consumption of gaming should be brought into conformity with that of other products, except where there are valid public policy grounds for industry-specific interventions. Many other products and activities involve risks and the possibility of misuse, yet they are not subject to anything like the degree of control and punitive taxation as gaming.

People derive substantial benefits from gambling. The vast majority of participants act responsibly. Present regulations aim to control the supply of gaming. This approach was rejected by the Laking working party in respect of liquor, where there is a much higher risk of injury to innocent parties. Most costs arising from the misuse of gaming are borne by the gambler and his or her household. Policies that target the misuse of gaming rather than responsible consumption are required to address social concerns. These are matters for the industry as well as the government. The risks of criminal activity, in a more open and competitive market, are overstated in the Department's paper.

The NZBR recommends that the Department adopt the following proposals:

- that gaming licensing be abolished to facilitate open competition among suppliers. Similarly, controls on the amount of bets and prizes should be removed, along with industry-specific restrictions on the remuneration of distributors, the ability to provide gaming for commercial gain and advertising;
- that young people who are supervised by a parent or guardian should generally be able to participate in gaming;
- that the minimum age at which young people can engage in gaming without parental consent should be reduced to between 16 and 18 years;
- that traders be permitted to establish the days and hours of business. If this recommendation is not accepted then it is recommended that gaming be made subject to the Shop Trading Hours Repeal Act 1990;
- that gaming duty and mandatory contributions to support community activities be abolished;
- that community activities that are currently funded from the net proceeds of gaming be funded from general revenue and be evaluated against other claims on taxpayers;

- that the government cease to be a provider of gaming services. The NZLC and the TAB should be stripped of their statutory privileges and then be privatised or, in the case of the TAB, be gifted to the racing industry; and
- that transitional arrangements should recognise explicit commitments to existing operators and provide private firms with an opportunity to adjust to the new environment.

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**SUBMISSION BY THE  
NEW ZEALAND BUSINESS ROUNDTABLE**

**LIQUOR REVIEW 1996**

**OCTOBER 1996**

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## EXECUTIVE SUMMARY

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- Beer, wine and spirits provide substantial benefits for those who choose to consume them. This is best shown by their willingness to buy liquor.
- A contemporary view of the effect on health of liquor recognises that moderate consumption can extend life.
- The vast majority of consumers of liquor act responsibly. Only a very small percentage of people engage in anti-social behaviour. Policies that target the misuse of liquor rather than responsible consumption are required to address anti-social behaviour.
- Some of the least desirable drinking habits were encouraged by inappropriate licensing and other restrictions. The relaxation of controls introduced by the Sale of Liquor Act 1989 (the Act) has contributed to a more mature and responsible approach to drinking.
- There has been a large increase in the number of liquor outlets since 1989 while the volume of per capita sales has declined. This outcome contradicts the prediction of those who claimed that greater availability of liquor would lead to increased consumption.
- The regulatory framework for the supply and consumption of liquor should be brought into conformity with that of other products, except where there are valid public policy grounds for industry-specific interventions.
- The Laking working party recommended a significant liberalisation of our liquor laws, but it did not advocate the dismantling of the heavy-handed and paternalistic regulation that distinguishes the distribution of liquor from that of other products. The present review should build on the Laking reforms in establishing an efficient regulatory framework that is appropriate for the 21st century.
- Young people, because of their immaturity, limited experience and knowledge, may not be able to make decisions which are likely to maximise their welfare. The prime responsibility for overseeing the purchase and consumption of liquor by young people should rest with their parents or guardians.
- Parents may face excessive costs in constraining the purchase and consumption of liquor by young people who are under their care and in monitoring their behaviour in this regard. Government regulation may enable such costs to be reduced. It may also be necessary to consider ways in which suppliers might better ascertain whether parents wish their children to consume liquor.
- The issue of a minimum drinking age revolves around the age at which young people are generally considered to be sufficiently mature to judge their long-term welfare and the willingness of the community to comply with, and support the enforcement of, a particular age limit.
- The Liquor Review Advisory Committee should examine whether suppliers of liquor should continue to be licensed.

- The main contemporary rationale for licensing is to further the enforcement of the prohibition on sales to under-aged drinkers and to intoxicated adults. This cannot possibly require the present heavy-handed and costly regulation of the supply of liquor.
- Open competition among firms offers the best opportunity to satisfy consumers' preferences at the lowest possible cost. The sale of liquor should not be restricted by licensing to particular classes of firms such as bottle stores, supermarkets, hotels, taverns, clubs and restaurants.
- The regulation of trading days and hours cannot be justified on the grounds of controlling sales to young drinkers or intoxicated adults. The only plausible rationale, aside from paternalism, is a belief in the discredited availability theory.
- The days and hours of supply of liquor for consumption on-premises or off-premises ought to be a matter to be determined by traders.
- Licensing trusts should be exposed to competition on as neutral a basis as possible.
- A sceptical view should be taken of industry-specific advertising restrictions and self-regulation of advertising, which is motivated in large part by the desire to avoid statutory regulation. Such restrictions harm consumers.
- The grounds for believing that consumers systematically underestimate the risks to their health from consuming liquor are dubious. The argument for requiring mandatory health warnings to be included on liquor labels and in advertisements is weak.
- This submission's recommendations are presented in section 8.

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# LIQUOR REVIEW 1996

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## 1 OVERVIEW

This submission is made on behalf of 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 which reflect overall New Zealand interests. Of particular relevance to the present submission is its view that consumer interests should be paramount in policy design.

Liquor has been consumed for thousands of years. Over 70 percent of women and 80 percent of men are reported to be drinkers (ALAC 1996). Beer, wine and spirits provide substantial benefits for those who choose to consume them. This is best shown by their willingness to buy liquor. Statistics New Zealand reports that on average households spent \$17.60 a week, or 2.6 percent of their weekly expenditure, on liquor in 1995/96. This is broadly comparable to the amount spent on each of the following categories of food: meat, poultry and fish (\$17.10), fruit and vegetables (\$16.90) and cereals (\$14.80).<sup>1</sup>

A contemporary view of the health benefits and risks associated with liquor is provided by the American Council on Science and Health (ACSH). ACSH is an independent consumer education and public health institution that is directed and advised by prominent American physicians and scientists.

Ellison (1993), who prepared ACSH's report, wrote:

The scientific evidence is now clear. Moderate alcohol use can extend life. Most studies on the health effects of alcohol conclude that moderate or light consumers – defined as those who consume an average of up to one or two drinks per day – have the lowest death rates. We believe this level of alcohol intake can be consistent with good health and is not associated with increases in those forms of death (like liver cirrhosis) which are known to be causally related to alcohol misuse.

ACSH concluded:

People who regularly consume moderate amounts of alcohol have significantly lower death rates than both non-drinkers and alcohol abusers. ... moderate drinkers not only have a lower risk of dying from coronary heart disease but also a diminished risk of death from any [health] cause.

Jackson and Beaglehole (1993), both of the University of Auckland, reviewed many studies in the medical literature relating to the effect on the risk of death from coronary heart disease of alcohol consumption. They concluded that:

An apparent protective effect of light-to-moderate alcohol consumption on the risks of coronary heart disease has been documented in numerous ecological, case-control and cohort studies. The findings are consistent and there are several biological effects of alcohol which could explain the findings. It has been argued, however, that the observed association is an artefact due to either the misclassification of ex-drinkers as never-drinkers or to confounding

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<sup>1</sup> Statistics New Zealand (1996).

factors. A series of recent studies have addressed these concerns and examined the possible biological mechanisms involved. These studies add support to the hypothesis that the inverse association between light-to-moderate alcohol consumption and coronary disease risk is causal.

Scragg (1995), in the first serious New Zealand study aimed at estimating the proportion of deaths caused or prevented by drinking, reported a net saving in lives of 416 (equal to 1.5 percent of all deaths) in 1987. This study presents a totally different picture from the 700-800 lives lost annually that is commonly cited.<sup>2</sup> Taking account of the age of people whose lives were saved or lost, Scragg concluded that a total of 9,525 person-years of life were lost. This result reflects the finding that young people tend to lose their lives mainly through accidents, whereas middle-aged and older people with a shorter life expectancy tend to have their lives extended.

Plant (1982) observed that:

The benefits from alcohol and drinking are highly underrated and under represented by specialists and those authorities concerned with a proper perspective on problem drinking.

Although the balance of professional opinion has shifted since 1982, some groups continue to argue that the consumption of liquor reduces community welfare. The Ministry of Health, for instance, released an issues paper in 1995 on a national policy on drugs which claimed that the "economic costs of alcohol" amounted to \$1,500 million (Ministry of Health 1995). The Ministry did not acknowledge compelling criticisms of an Australian report on which the estimate was based.<sup>3</sup> Devlin *et al.* (1996) suggests that the "social cost of alcohol abuse" was between \$1.5 and \$2.4 billion in 1991. This estimate omitted any benefits from the consumption of liquor despite an acknowledgment by Devlin *et al.* that they are generally recognised in the literature. Their finding is included in the Alcohol Advisory Council of New Zealand's (ALAC) 1996 Fact Pact without qualification (ALAC 1996).

Such studies are seriously flawed as a basis for public policy making.<sup>4</sup> The broad issue for public policy is not the level of gross or even net social costs but whether people bear the economic costs of their consumption decisions (that is, that all costs which are external to the consumer are imposed on the consumer where it is efficient to do so).<sup>5</sup> In the case of young people, the principal issue is whether they are sufficiently mature to take decisions that advance their welfare. Neither the studies cited by the Ministry of Health (1995) nor that by Devlin *et al.* (1996) address these issues.<sup>6</sup>

<sup>2</sup> See, for example, Ministry of Health (1995).

<sup>3</sup> The Australian study referred to is Collins and Lapsley (1991). For a critique of their methodology see ACIL Economics & Policy Pty Ltd (1994).

<sup>4</sup> For an example of a rigorous analysis of a health issue from a public policy perspective see Philipson and Posner (1993).

<sup>5</sup> The Laking working party noted this critical point. See Castle (1986).

<sup>6</sup> The largest cost item noted by Devlin *et al.* (1996) was excess unemployment among alcohol abusers, which amounted to between \$369 and \$1,108 million depending on assumptions. The cost of unemployment is primarily borne by affected workers and their families rather than by other members of society. Some other cost items included in the estimate are also met by the affected consumer rather than society.

The vast majority of consumers of liquor act responsibly. Only a very small percentage of people engage in anti-social behaviour.<sup>7</sup> Policies that target the misuse of liquor rather than responsible consumption are required to address anti-social behaviour. This approach is similar to that taken in respect of motor vehicle accidents. Greater mobility is rightly seen as a benefit of higher living standards, and strategies to reduce accidents are targeted at their specific causes. The problem does not relate to people who drive, or even to those who drive a lot, but to those who cause accidents.<sup>8</sup> A similar approach in respect of liquor requires policies directly targeted at its misuse.

Some of the least desirable drinking habits were encouraged by inappropriate licensing and other restrictions, such as the construction of large on-licence establishments that were commonly referred to as booze barns and 6 o'clock closing. The relaxation of controls introduced by the Sale of Liquor Act 1989 (the Act) has contributed to a more mature and responsible approach to drinking. The volume of per capita consumption of liquor has declined despite a large increase in the number of outlets.<sup>9</sup> This outcome contradicts the prediction of those who claimed that the greater availability of liquor would lead to increased consumption. Moreover, there has been a fall in the rate of fatal accidents that are reported to be alcohol-related.<sup>10</sup>

Since 1984 successive governments have placed greater focus on their core role of setting the framework which enables individuals and firms to interact in ways that maximise community welfare. The supply of goods and services has increasingly been viewed as the function of private enterprise, except in certain exceptional circumstances. Competition has correctly been seen as the key to encouraging producers and distributors to satisfy consumer preferences at the lowest possible cost. The vast majority of New Zealanders endorsed these broad policy directions at the recent general election. The review of the Act provides an opportunity to apply them more consistently to the distribution of liquor.

The supply and consumption of liquor are heavily regulated. The minimum drinking age is controlled, suppliers are licensed, managers are required to be certified, trading hours and days and liquor advertising are subject to industry-specific rules, and public enterprises – licensing trusts – are protected from competition. Liquor is subject to substantial excise taxes. These provisions extend well beyond those applicable to most other products. They impair competition and lead to higher prices and lower quality service than otherwise, waste resources from a community perspective and inhibit innovation.

The thrust of this submission is that the regulatory framework for the supply and consumption of liquor should be brought into conformity with that for other products, except where there are valid public policy grounds for industry-specific

<sup>7</sup> Devlin *et al.* (1996), for example, assume that abusers constitute 4.3 percent of the population. In 1986 Bailey reported that people who drink sufficient quantities of liquor to be likely to have a fatal accident if they subsequently drive a motor vehicle probably constitute between 2 and 5 percent of the adult population. See Bailey and Carpenter (1992).

<sup>8</sup> Research by Bailey shows that 37 percent of drunk drivers who were responsible for fatal accidents had two or more prior convictions for theft, burglary, violence, illicit drugs or alcohol-related offences. Just over half of such drivers had two or more convictions for serious driving offences (Quay Group 1995b). These findings illustrate the point that the focus should be on deviant behaviour.

<sup>9</sup> Bushnell, Carter and Howden-Chapman (1994) show that average consumption of beer, wine and spirits by people aged 15 years and over has fallen by about 20 percent since 1978. The Quay Group (1995b) reported that the number of licensed outlets more than doubled between 1980 and 1993.

<sup>10</sup> Quay Group (1995b) and Bailey *et al.* (1995).

interventions. Many other products or activities – food, transport equipment, sport and recreational activities and so forth – involve risks and the possibility of abuse, yet are not subject to anything like the degree of control and punitive taxation as liquor. While there are grounds for some restrictions on the minimum drinking age, virtually all other industry-specific regulations cannot be justified on accepted public policy criteria.

The Laking working party recommended a significant liberalisation of our liquor laws.<sup>11</sup> However, it did not go far enough in dismantling the heavy-handed and paternalistic regulation that distinguishes the distribution of liquor from that of other products. Moreover, its proposals were not adopted fully.

The present review should build on the Laking reforms in establishing an efficient regulatory framework that is appropriate for the 21st century. The key steps required include:

- the adoption of more appropriate rules relating to the supply of liquor to young people. Such rules should be soundly based, command the support of the community and be properly enforced. A decrease in the minimum drinking age is recommended;
- the abolition of liquor licensing. The control of the consumption of liquor by under-age drinkers and intoxicated adults is not sensibly addressed by licensing traders. Furthermore, present arrangements limit competition and waste resources by imposing unnecessary compliance and administration costs on the community. Any class of business should be able to sell liquor;
- the removal of controls on trading days and hours or, at least, bringing the supply of liquor under the provisions of the Shop Trading Hours Repeal Act 1990;
- the introduction of competition for licensing trusts;
- the removal of restrictions on liquor advertising and promotion; and
- a review on a first principles basis of excise duties.

The above measures would enable the Act to be repealed with residual matters, such as the drinking age, included in the Crimes Act 1961. The efficiency of the distribution of liquor would increase substantially, thereby conferring benefits on responsible drinkers and the wider community through a more efficient use of resources.

This submission addresses all issues listed in the Ministry of Justice's discussion paper, *Liquor Review 1996*, except the definition of intoxication and technical issues.<sup>12</sup>

The balance of this submission is presented in 7 sections. The next section (section 2) addresses the minimum drinking age, including the issue of identification cards. The regulation of traders is examined in section 3. The question of whether particular classes of business should be licensed to supply liquor and whether trading hours and days should be restricted is also discussed. Section 4 focuses on licensing trusts. Sections 5 and 6 address liquor advertising and promotion, and health warnings respectively. Excise taxes are discussed in section 7. Conclusions and recommendations are presented in section 8.

<sup>11</sup> Laking *et al.* (1986).

<sup>12</sup> Ministry of Justice (1996).



## 2 THE MINIMUM DRINKING AGE

### 2.1 Conceptual Approach

The establishment of a minimum drinking age or ages is arguably the most important issue in the regulation of liquor. If the supply of liquor to young people were not prohibited, the justification for industry-specific regulation of the distribution of liquor would vanish.

An economic approach to the question of whether there should be restrictions on the drinking age and, if so, the broad nature of such limits starts from the proposition that, unless special factors apply, liquor should be treated like most other goods and services for regulatory and taxation purposes. Its consumption should be a matter for individual choice and responsibility. The next step is to examine whether there are valid grounds for specific government intervention. The costs and benefits of any intervention would then need to be assessed.

Society generally accepts that individuals can make rational choices – not in the sense that they do not make mistakes, but that they do not systematically act against their interests. Aside from a few products that are prohibited from sale or distribution, such as illicit drugs, or those that are sold subject to special conditions, like firearms, traders are entitled to supply goods and services, and adults of sound mind are able to choose whether to buy them.

Young people, because of their immaturity, limited experience and knowledge, may not be able to make decisions which are likely to maximise their welfare. This, for example, is the economic rationale for limits on the capacity of minors to enter into enforceable contracts. However, parents (and other people who act in their place, such as guardians) can be expected to oversee the decisions of their children. Parents are generally assumed to act in the best interests of young people because they have stronger incentives to do so than any other person or agency (Becker 1991). For this reason, the rights of parents to act for children should generally be upheld and interventions restricted to clear cases of negligent or abusive behaviour.

The prime responsibility for overseeing the purchase and consumption of liquor by young people should rest with their parents. On this basis the supply of liquor to children would be prohibited where the relevant parent (or guardian) did not explicitly authorise their child's actions (for example, when the parent is not present). This approach would imply an extension of the exemptions that apply at present. It would, for instance, suggest that there should be no age limit on the consumption of liquor by children who are with a parent, just as the present law does not attempt to regulate the consumption of liquor by young people in their homes. Most liquor is consumed off-premises.

The discussion to this point is predicated on the presumption that parents are capable of making informed decisions. The supply of liquor to people under the minimum age should not be able to be authorised by a parent who is intoxicated.

Parents may face excessive costs in constraining the purchase and consumption of liquor by young people who are under their care and in monitoring their behaviour in this regard. Government regulation may enable such costs to be reduced. It may also be necessary to consider ways in which suppliers might better ascertain whether parents wish their children to consume liquor. The issue of identifying parents and guardians might be troublesome. On these grounds it may be efficient to impose some additional constraints on the supply of liquor to young people. It would be necessary for society to judge that the benefits, in terms of bringing young people's pattern of liquor purchase and consumption closer to that approved by their parents, outweigh the costs involved. The latter include administration and

compliance costs, and interference with the freedom of those parents whose preferences would be unable to be satisfied.

A related issue is the minimum age at which the consent of parents would not be required to buy or consume liquor. This relates to the age at which young people are generally considered to be sufficiently mature to judge their long-term welfare and the willingness of the community to enforce a particular age limit. For a range of activity, the former is generally between 16 years (for a full driver's licence and to appear before the District Court) and 18 years (for the right to make a will, enter into an enforceable credit contract without parental consent, obtain a firearm's licence, vote in a general election, undertake jury service, serve in the defence forces and go to war). While 16 years is the minimum age at which a person can be married, people under the age of 20 generally require their parent's consent. The school leaving age is to be set at 17 years. By contrast the present minimum drinking age is generally 20 years, but in some circumstances it is 18 years.

The apparent widespread breach of the present law suggests that it is not supported by a large section of the community. According to research summarised by the Alcohol and Public Health Research Unit (1996), men and women between the ages of 18 and 19 have the second highest mean level of alcohol consumption for all age groups of men and women respectively. Only 20-24 year olds recorded a higher mean consumption than 18-19 year olds. Moreover, nearly a third of 14-19 year olds surveyed claimed to have consumed liquor in hotels in the previous year, and some 38 percent claimed to have bought liquor for off-premise consumption. These findings suggest that any attempt to constrain the supply of alcohol to at least 18 and 19 year olds is doomed to fail, unless there is a substantial change in community attitudes to liquor consumption by young people. This seems unlikely.

A minimum drinking age in the 16-18 years range is supported by the policies adopted by comparable countries. A survey of 23 developed countries by the Brewers Association of Canada (1993) revealed that:

- two countries (Belgium and Portugal) have no age limit;
- seven countries (Austria, France, Germany, Italy, the Netherlands, Spain and Switzerland) have set the minimum legal drinking age at 16 years;
- 10 countries (Australia, Denmark, Finland, Ireland, Luxembourg, Norway, Poland, South Africa, Sweden and the United Kingdom) have adopted 18 years; and
- four countries have set an age limit above 18 years. Canada has an age limit of 18 or 19 years depending on the province or territory. The age limit in New Zealand and Japan is 20 years, while the United States has adopted 21 years.

There are some exceptions to the above summary. Several countries have no limit (France and Spain, and two provinces of Canada) or a lower limit (Luxembourg and New Zealand) where a person who would otherwise be under age is accompanied by an adult, parent or guardian, or when dining (New Zealand and the United Kingdom). Belgium prohibits anyone under 16 entering a dance hall where fermented beverages are served, or other licensed establishments where there is dancing, unless the person is accompanied by a parent or guardian. Denmark has no age limit for the off-premise purchase of liquor. In one or two countries a slightly higher age limit applies where spirits are consumed.

## 2.2 Laking Working Party and the Discussion Paper

The Laking working party was of the opinion that much of the literature supported its view that the level of enforcement was more important than the age at which people are permitted to drink. It concluded that:

- the problem of alcohol abuse by young children can be tackled effectively only through a process of education of both children and parents;
- any legal minimum age requirement, if it is to command public support, must be seen to have some logical basis in the New Zealand context; and
- the legal age must be capable of more effective enforcement than was the case when the working party's report was prepared.

On this basis, the Laking working party recommended that:

- the drinking age be fixed at 18 years;
- persons under 18 years should not be permitted to consume liquor on licensed premises in any circumstances;
- the licensing authorities be empowered to designate, in respect of any establishment, the areas from which persons under 18 years are prohibited (restricted areas); and
- the licensing authorities should be empowered to designate areas to which persons under 18 years may have access only if accompanied by an adult spouse, parent, guardian or any other adult acting in place of a parent (family areas).

Parliament did not accept the Laking working party's recommendation that the minimum drinking age be reduced to 18 years. It set 20 years as the minimum drinking age in most cases and introduced a range of age limits which apply depending on the designation of the premises and the circumstances.

In presenting arguments for the *status quo* option, the discussion paper suggests that a lowering of the age at which young people may legally buy alcohol and consume it in restaurants, hotels, taverns and clubs may lead to a rise in the road toll. Drawing on US research it suggests that:

There is overwhelming evidence that lowering the legal drinking age would lead to more road accidents, road deaths and more alcohol-related problems.

A lower age limit would also result in:

... an increase in juvenile crime, non-traffic accidents, violence and attempted suicides.

Moreover:

... while the minimum age, *de jure*, is 20 years, many believe the *de facto* minimum age is lower, so if the minimum age was lowered then the *de facto* age would drop even further to that of 16 years.

There are several responses to these arguments. They include the following:

- policies aimed at addressing the abuse of alcohol should be targeted at its misuse. The argument that a lower age limit would increase accidents could be advanced in support of prohibition as all alcohol-related accidents and anti-social behaviour would be avoided if no alcohol were consumed. This would be an inefficient policy because it would be widely disregarded, and it ignores the benefits that responsible drinkers, including young ones, derive from liquor. These and other benefits need to be taken into account if an appropriate policy is to be put in place;
- while the drinking age restricts the purchase of liquor and its consumption on the trader's premises, it is of limited effect in controlling the consumption of liquor by young people in other places away from direct parental control because of the willingness of adults to supply liquor to them. Is it better to allow young people to consume liquor in a civilised manner, with adults and where responsible attitudes can be encouraged, rather than in cars and public parks?
- similar arguments were advanced in relation to proposals introduced in the Act to relax controls on the availability of liquor. There has, however, been a reduction in road fatalities since 1989 despite a large growth in the number of registered motor vehicles. This is not surprising. It probably reflects rising per capita incomes, higher spending on safety, such as improvements in roads and motor vehicles, better enforcement of certain rules of the road, higher penalties for serious offences and publicity campaigns; and
- laws which do not command the general support of the community and which are not appropriately enforced are bad laws. They undermine the integrity of our legal system and its institutions. They encourage otherwise law-abiding citizens to become criminals. The present drinking laws are not enforced because they do not command the support of a large section of the population and because they are a low priority from a policing perspective. There are no circumstances which would justify support for an intentional gap between the *de jure* and *de facto* age limits.

While the age of 18 years has been proposed as an alternative, it is possible that an age limit between 16 and 18 years may be necessary to achieve community support for its enforcement. Community support in this context involves:

- a willingness by the majority of parents to require their children to comply with the law. The focus should be placed on the views of parents who are likely to permit drinking by their children at possible drinking ages and not on those who are opposed to drinking and are unlikely to allow their children to consume liquor at any age. It is decisions at the margin which matter most. This aspect is critical to achieving a high level of voluntary compliance;

An age limit of 18 or 20 years with no exceptions at all, as has been suggested, would fail to satisfy this criterion. Most parents introduce their children to liquor, often at a quite young age, and would be willing for them to consume, for example, when dining. What is more, how can young people be expected to learn to act responsibly if they are denied the opportunity to consume liquor under the supervision of their parents in civilised surroundings as they approach full maturity?

- a commitment by most industry participants to apply the law. They need to encourage compliance by young people and support the decisions of parents. This won't happen if industry participants believe that the minimum drinking age is too high and is not considered important by parents and the wider community;

- an appropriate level of enforcement by the police. The police must judge the relative priority to be accorded to the enforcement of drinking and other laws. The minimum drinking age needs to be set at an age where enforcement is perceived to be a reasonable priority; and
- the imposition of deterrent sanctions by the courts where breaches are proven to have occurred. Penalties, together with a subjective assessment of the likelihood of being successfully prosecuted, indicate to young people the expected cost of breaking the law. As this cost rises, the likelihood that young people will try to break the law and take the risk of being convicted will decline. This point also applies in respect of offences for supplying liquor to under-aged drinkers.

There is also the need to contain pressures for exceptions. Too many exceptions would make the suggested approach difficult to apply.

### **2.3 Conclusion on the Drinking Age**

The key conclusions which emerge from the above discussion are that:

- young people under the minimum age who are being supervised by a parent or guardian should generally be able to buy and consume liquor; and
- the minimum age at which young people can buy and consume liquor without parental consent should be set between 16 and 18 years.

### **2.4 Identification Cards**

The introduction of compulsory identification cards to provide proof of a person's age solely or mainly for the purposes of enforcing liquor laws could not possibly be justified. The costs of coercion together with administrative and compliance costs could be expected to far exceed the benefits.

Any proposal to introduce a national identification system for other purposes, such as traffic enforcement or to further the administration of tax and income support systems, would raise significant civil liberty issues. It would need to be carefully considered and is beyond the scope of the Advisory Committee.

The Laking working party's approach, which emphasises the right of traders to refuse service where there is any doubt about a person's legal right to buy or consume liquor, together with voluntary identification arrangements, are sufficient. The efficacy of that approach would be enhanced if the minimum age is lowered to a level which is supported by the community.

## **3 REGULATION OF TRADERS**

### **3.1 Classes of Businesses Which May Sell Liquor**

The discussion paper examines whether supermarkets and grocery stores should be permitted to sell beer and spirits. They are presently able to sell wine other than in a dry or trust area. The discussion paper is insufficiently searching in its review. The Advisory Committee should examine whether suppliers of liquor should continue to be licensed.

The Laking working party identified two main objections to the liberalisation of the distribution of liquor. First, there were submissions which argued that the more liquor is available, the higher consumption would be. The second argument related to the protection of existing traders from competition. The Laking working party rejected both views. It did, however, comment that:

... because of our concern about drinking and driving, we think it inappropriate that a service station should be granted an on-licence or an off-licence.

Parliament did not fully accept these recommendations. It prohibited dairies from selling liquor and it limited supermarkets to selling wine (and low strength beer which is not defined as liquor for the purposes of the Act). Parliament agreed that service stations should not be permitted to sell liquor.

The Liquor Licensing Authority (LLA) noted that there is no clear distinction among a grocery, superette and a dairy. As a consequence, it has been asked to make what it terms "some peculiar decisions." In the LLA's view, the relevant section of the Act needs to be reviewed because of this and other drafting difficulties.

The Laking working party's view that service stations should be prohibited from selling liquor is questionable. It is, for example, legitimate to drive to a licensed outlet or for an outlet to be located near a service station. In one decision of the LLA, an off-licence was granted to a business which was renting the former lubrication bay of a service station because the premises were next to and not part of the service station.<sup>13</sup>

While drinking and driving is a serious problem, it affects a minority of the population. A restriction on liquor sales by service stations seems to be an inefficient method of addressing the drink-drive problem. No one would seriously suggest that service stations should be prohibited from selling matches and cigarettes because their misuse in the presence of petrol could have tragic consequences.

A survey of 23 countries by the Brewers Association of Canada (1993) shows that the supply of liquor to consumers is generally licensed. There are, however, some exceptions, particularly in relation to the supply of liquor for off-premise consumption. The degree of restriction imposed by licensing varies. The extent to which licensing requirements are enforced is not known.

Sellers of liquor for both on- and off-premise consumption are not licensed in Spain. Off-premise sales are not subject to industry-specific licensing in Austria, Denmark, Germany and Portugal. It is said that a person can buy beer in Germany for off-premise consumption anywhere he or she can purchase milk. In Japan and Portugal, restaurants and bars are not required to obtain a special licence to sell liquor. In the Netherlands, beer and wine may be sold for off-premise consumption from any stores that are licensed to sell food. In Luxembourg beer can be sold in unlicensed premises that sell food such as restaurants and snack bars.

The discussion paper argues that one reason for permitting the sale of wine by supermarkets and grocery stores is that it is considered to be an adjunct to food, and it is therefore appropriate that people should be able to buy it at the same time as they purchase food. This argument has connotations of a centrally planned distribution system. The essential argument for allowing firms to sell liquor is to

<sup>13</sup> This refers to an application by R W Hensen and Liquor Licensing Authority decision 1612/91.

encourage competition, thereby encouraging them to satisfy consumer preferences at the lowest possible cost.

The main contemporary rationale for licensing is to further the enforcement of the prohibition on sales to under-age and intoxicated drinkers. This cannot possibly require the present heavy-handed and costly regulation of the supply of liquor.

The Act reflects the view that the availability of liquor should be controlled to reduce abuse and that particular classes of firms such as hotels, taverns, clubs and off-licences should be subject to different regulatory requirements. The outcome is a reduction in competition leading to higher distribution costs and lower quality services. Moreover, large deadweight costs, arising from a substantial licensing apparatus, are imposed on the community. One of the major costs of licensing is the delay involved. According to industry sources it takes around six months to obtain an on-licence.

Open competition among firms offers the best opportunity to satisfy consumers' preferences at the lowest possible cost. For this reason, the sale of liquor should not be restricted to particular classes of firms such as bottle stores, supermarkets, hotels, taverns, clubs and licensed restaurants. The price differences among fully licensed, BYO (bring-your-own) and unlicensed restaurants reflect impaired competition and the direct costs of the licensing system as well as perceived differences in the quality of service. This is an efficiency rather than a fairness argument, as the discussion paper suggests. In our view liquor licensing should be abolished.

There may be grounds for identifying premises or businesses which are engaged in the supply of liquor, if this is necessary to enforce the minimum drinking age and a prohibition on sales to intoxicated people. These grounds are, however, unlikely to be sufficient to justify detailed registration procedures or licensing. Restrictions on the sale of books and similar publications to people under certain ages do not, for example, require the licensing of booksellers.

The present requirement for reports from health and fire safety perspectives duplicate separate regulatory provisions. The distinctions among restricted, supervised and undesignated areas in licensed premises reflect the view that young people should not be present in certain areas such as public bars, but should be able to use licensed dining rooms and conveyances such as aircraft and trains. They complicate the present rules, are poorly understood by the public and impede enforcement. Such distinctions are unnecessary. Similarly, it is not immediately obvious why laws relating to the closure of licensed premises in the case of serious disorder (riot) ought not to apply regardless of the nature of the activities that are taking place (for example, the consumption of liquor, demonstrations, sporting events and rock concerts).

The economic grounds for requiring managers of on-licensed premises to be suitable persons relates to the enforcement of hours of trading and age limits. Licensed managers who persistently break such rules may be unable to renew their licences. On the first point, it is proposed below that the hours of sale be deregulated. The age limit would be less of a problem if rules that are broadly supported by the community were put in place.

If it is necessary to identify the person responsible for the sale of liquor to facilitate enforcement, firms that sell liquor might be required to display the name of the duty manager as at present. There is little justification, however, for certification requirements and insufficient grounds to require managers to complete New Zealand Qualifications Authority or other recognised training as suggested in the discussion paper.

There have been suggestions that a minimum age should be set for all staff who sell liquor to the public. The responsibility for compliance with the law should rest, in the first instance, with business owners and managers. They appoint staff and arrange for their training. No person under the school leaving age (soon to be 17 years) would normally sell liquor without supervision by a manager or owner. Staff also have a responsibility to comply with the law. This applies in respect of liquor, cigarettes and restricted publications and videos, and to the general law such as food regulations. Age limits have not been imposed for these comparable activities. They would impose considerable costs initially on traders, such as restaurants and supermarkets, and ultimately on consumers.

The appropriate penalty for selling to under-age or intoxicated persons should generally be a fine rather than a prohibition on a person's means of livelihood. (There may be grounds for reviewing the level of penalties.) Provision could be made to prohibit a person who habitually sells liquor to under-age drinkers or intoxicated persons from selling liquor, but this would not necessarily require all managers to be certified. Some people are prohibited from becoming a director of a company but this does not require all other directors to be certified.

Any provisions along the above lines should be included in the Crimes Act 1961. There is no need to retain the Sale of Liquor Act 1989. The district licensing agencies and the LLA should be abolished with a significant saving in administration and compliance costs. The LLA alone expects to determine 7,200 applications in 1996/97.

### **3.2 Trading Days and Hours**

The Department's discussion paper notes that there are concerns with the differential treatment of particular classes of licence holders, and there are problems with what is meant by the expression "for the purposes of dining". It notes that all licence holders could be permitted to trade on Sundays or no licence holders could be permitted to trade on Sundays. These are not the only options that should be considered. The Advisory Committee should examine seriously why there should be any special regulation of trading hours or days in respect of liquor.

The Laking working party concluded that the abandonment of any legislative provision imposing minimum or maximum hours for hotels and taverns would have little, if any, impact on the time that they are open for business, or on consumption. As a consequence, it did not propose to prescribe the days or hours of trade for on-licences, off-licences or club licences. However, the hours of trade were included as a criterion for the issue of such licences and provision was made for the LLA to specify such hours in granting licences. The basis on which the LLA was to decide applications was not stated.

Parliament did not accept fully the Laking working party's recommendations. It decided that trading on Sundays, Good Friday and Christmas day should be prohibited as a condition of all on-licences, off-licences and club licences. Exceptions were provided for lodgers and employees of the licensee and for any person who was present on the premises for the purposes of dining. For those entities which had been permitted to trade on a Sunday (for example, clubs), this represented a tightening of the rules.

In 1991 the sale on Sundays of grape wine or fruit wine made on the premises, pursuant to a licence issued under the Wine Makers Act 1981, was authorised.



Since 1 August 1990, most shops have been free to trade 24 hours a day except for Christmas day, Good Friday and Easter Sunday, and up to 1 pm on Anzac day.<sup>14</sup> The ban on Sunday trading in liquor is more restrictive than that applying to most businesses.

The LLA reported that the pattern of trading hours generally approved during the 15 months to June 1991 was as follows:

- 24 hour licences for hotels and taverns or licences to trade until 3 am where there are no neighbouring residential properties. (Contrary to the explicit provisions of the Act, the LLA has authorised trading between midnight on Saturday and 3 am on Sundays);
- trading until 11 pm Monday to Thursday and midnight or 1 am on Fridays and Saturdays depending on the proximity of neighbouring residential properties; and
- Sunday hours restricted to lodgers in hotels or persons present on the premises for the purposes of dining in hotel or tavern dining rooms.

The LLA reported that 24-hour trading has generally been accepted without any great public outcry or the creation of additional problems for the police.

The LLA has generally set 11 pm as the latest hour for trade by off-licence holders. One authority has noted that the LLA does not have the power to adopt this stance and that it is inconsistent with the Laking working party's report (Dormer, Sherriff and Crookston 1990).

The Laking working party rejected the notion that controls on the availability of alcohol were an efficient method of limiting alcohol abuse. In these circumstances, restrictions on the hours and days on which alcohol may be consumed can be expected to have the following adverse economic effects:

- they alter the pattern of consumption. Consumers who would prefer to drink at a hotel or tavern are required to go without, to consume at another venue such as at home, or to consume when trading is permitted. This interference with their preferences imposes a cost on them;
- they require consumers to subject themselves to an ordeal to consume alcohol during prohibited hours.<sup>15</sup> This might involve buying a meal, joining a club or travelling to an airport bar that has less restrictive licensing terms, or buying alcohol in advance for later off-premises consumption.

An ordeal is an inefficient method of allocating goods and services among consumers because it results in a waste of resources (for example, the otherwise unnecessary trip to an airport bar). The ordeal is of no benefit to the seller as it does not signal the value of the service which is provided and thus disrupts market responses. An ordeal also forces consumers to choose between the product which they wish to acquire and the one which they must give up to do so. Similar constrained choices are not required under price rationing. Finally, the money-equivalent price of the ordeal differs from person to person. (Note the tendency for old people and children rather than

<sup>14</sup> These provisions are contained in the Shop Trading Hours Repeal Act 1990 which is administered by the Industrial Relations Service of the Department of Labour.

<sup>15</sup> A common ordeal is the requirement of some local authorities that hand-held hoses only may be used to water gardens during summer. The ordeal referred to here is additional to that which might otherwise be required (e.g. a trip to the consumer's preferred outlet).

people of working age to queue for food in the former Eastern European countries.) For these reasons, ordeals are Pareto-inefficient;<sup>16</sup>

- they distort the pattern of production and distribution. For example, packaged liquor is favoured relative to on-tap beverages. The location of production and distribution facilities reflects the pattern of trade which emerges under current regulation rather than that which would emerge under an alternative set of rules. Organisational forms which have more liberal trading hours are favoured relative to others (for example, clubs relative to hotels);
- they require resources to be committed to the administration of, and compliance with, the regulations. Delays arising from the need to prepare a submission and obtain approval impose further costs on suppliers. In addition, resources are committed to lobbying to obtain favourable rules and outcomes from administrative bodies. Lobbying activities tend to favour well organised and well-off groups at the expense of others. Resources devoted to lobbying are wasted from society's point of view (that is, total output is reduced); and
- they penalise minority groups whose work and recreational activities occur at less common times. Small communities are penalised relative to large ones because the former are likely to be serviced by a narrower range of suppliers (for example, the distribution of airports affects the availability of liquor).

The response of consumers and producers to the liberalisation of shop trading hours demonstrates that restrictions on trading hours, even apparently innocuous ones, can impose significant costs. It is also apparent that no government has reliable information on such costs. On the other hand, to the extent that the present procedures tend to be non-constraining, they impose unnecessary compliance and administration costs on the community.

The regulation of trading days and hours cannot be justified on the grounds of controlling sales to under-age people or intoxicated adults. The only plausible rationale, aside from paternalism, is a belief in the discredited availability theory. Issues relating to the location of outlets, noise and nuisance to neighbours are matters that should be addressed under the Resource Management Act 1991 and not under the Sale of Liquor Act 1989. This point applies to the suggestion in the discussion paper that people should be able to object to the issue of an application for a licence on the grounds that the premises are or will be in the immediate vicinity of a place of public worship, a hospital or a school.

The days and hours of supply of liquor for consumption on-premises or off-premises ought to be a matter to be determined by traders (first preference) or made subject to the Shop Trading Hours Repeal Act 1990 (second preference). The establishment of separate rules for selected goods and services, as presently applies to wine in supermarkets, imposes unnecessary costs on traders.

The restrictions on trading days contained in the Shop Trading Hours Repeal Act 1990 are an anachronism which reflect a conflict model of employment relationships and are out of step with the preferences of most consumers. If liquor is brought within that Act, provision would need to be made for a continuation of trading on Anzac morning and for sales on Christmas day, Good Friday and Easter Sunday to diners, lodgers and employees to avoid any unintended tightening in the controls.

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<sup>16</sup> Pareto efficiency is achieved when it is not possible to make one person better off without reducing the welfare of another.

Under both options traders would respond to commercial pressures as is the case for dairies and service stations.

#### 4 LICENSING TRUSTS

The Laking working party concluded that neither public nor private control of liquor sales could claim greater success in the struggle against liquor abuse. It also noted that the rationale that trusts made a substantial financial contribution to the community was a doubtful one. For these reasons, the Laking working party recommended that:

- the same licensing rules should apply throughout the country;
- licensing trusts should no longer retain any sole rights or privileges beyond those enjoyed by private enterprise; and
- trusts should be relieved of many of the restrictive provisions that limit trustee powers.

The Act provides that a trust may be constituted by Order in Council by the governor-general who acts on the recommendation of the minister of justice. The Minister in turn is required to advise the governor-general on receipt of a written request to form a trust from at least 15 percent of qualified local authority voters in the area. There is also provision for the amalgamation of trusts. A trust may hold a poll of electors on a proposal that the trust give up its exclusive right to hold on-licences, off-licences and club licences in return for the right to carry on any business within its objects outside as well as within its district. Unless such a poll is successfully carried, certain trusts have a monopoly right to hotel or tavern licences, and they are largely protected from competition in respect of other licences. A supermarket in a trust area, for instance, cannot sell wine. These rights are able to be extended to new trusts.

Since the Laking working party's report was finalised, considerable evidence has emerged on the way in which public ownership, particularly when coupled with other impediments to competition, leads to inefficiency. The residual owners of public enterprises have little stake in the firm. They therefore have few incentives to monitor its management. This leads to excessive costs and a divergence between the interests of the owners and those of other stakeholders such as managers. The lack of competition impairs cost control, reduces choice for consumers and impedes innovation. The corporatisation and privatisation process in New Zealand and elsewhere has shown that these costs are often substantial.

The provisions contained in the Act are intended to facilitate the voluntary removal of the preferred status conferred on trusts, consistent with the Laking working party's view that there are no economic grounds for their competitive advantages. Trusts are, however, unlikely to act in this way.

Licensing trusts should be exposed to competition on as neutral a basis as possible. This is consistent with the view that the licensing of liquor outlets should be abolished. Trusts will only survive in a competitive environment if they offer the service demanded by consumers. Provision should be made for their sale. The proceeds could be applied for charitable community purposes in the areas in which the trust operated.

## 5 ADVERTISING AND PROMOTION

The advertising of liquor through broadcast media is subject to significant controls which are administered by the Advertising Standards Authority (ASA). The ASA is a self-regulatory body which is supported by the industry in large part because statutory regulation would otherwise be imposed. It administers a code of practice and services the Advertising Standards Complaints Board. Broadcasters are required to provide \$3 million a year in unpaid time to promote moderate consumption of liquor. These arrangements are uncharacteristic of the general run of commerce.

The thrust of the discussion paper is that present arrangements for advertising and promotion, recently reviewed by a team appointed by the ASA, are satisfactory.<sup>17</sup>

Product-specific controls on liquor advertising are usually advocated on the grounds that advertising encourages consumption that is harmful to society, including that by vulnerable members of society such as young people.<sup>18</sup> An economic perspective of advertising provides a contrary view. This is outlined below:

- advertising is associated with the freedom of speech which belongs to the domain of rights and duties. Those rights are fundamental to the freedom and dignity of people. The preservation of them, subject to some limits, is normally seen as a key function of democratic governments and may take precedence over efficiency (Okun 1975 and Gray 1992). While Potter *et al.* (1994) accepted legal advice that a ban on liquor advertising and sponsorship could breach the New Zealand Bill of Rights Act 1990, they did not examine whether the present restrictions were consistent with the Act or more general principles of freedom;
- advertising reduces the cost to consumers of identifying sellers, obtaining information on alternative products and other goods and services that are available, and comparing products' relative prices. Because advertising facilitates competition, it also generally results in lower quality-adjusted prices.<sup>19</sup> These benefits of advertising enhance the welfare of consumers. Potter *et al.* (1994) omits any serious consideration of the benefits of advertising to general consumers. One of its main points, for example, was that sponsorship advertising is "justified given its importance to the promotion of sport and other activities". This is an irrelevant justification from a public policy perspective. The Potter report is notable for the omission of an appropriate conceptual framework and adequate information to make valid decisions on liquor advertising;
- there are no compelling grounds for believing that advertising can have a large impact on aggregate consumption of liquor because relative prices and income largely explain demand.<sup>20</sup> Advertising expenditures are generally believed to have a limited impact on aggregate demand and a more significant impact on the distribution of sales among competitors;

<sup>17</sup> See Potter *et al.* (1994).

<sup>18</sup> See von Dadelszen (1979). The Toxic Substances Board (1989) sought an end to tobacco advertising on similar grounds. Its report was severely criticised on methodological grounds and for its lack of scientific rigour by Justice Jean-Jude Chabot in the Quebec Superior Court. See Luik (1991).

<sup>19</sup> See, for example, research reviewed by Pauly (1986) relating to restrictions on the advertising of medical services and supplies.

<sup>20</sup> See Smart (1988) for a review of empirical evidence.

- if a reduction in the price of alcohol products were worth more to consumers than advertising expenditure, consumers would voluntarily demand less advertising and lower-priced brands, and producers would also exploit this opportunity. (The supply of 'no frills' products in supermarkets is a partial example of this response.<sup>21</sup>) This proposition illustrates the point that advertising conveys information relating to the quality of products – for instance information on the uniformity of the product, its taste and the reliability of the quantity supplied – and does not just reduce search costs (Schneider, Klein and Murphy 1981 and Barzel 1982);
- controls on advertising reduce the marginal efficiency of advertising expenditure and thereby impose a deadweight cost on the community. Restrictions on the style of advertising (over and above valid ones that apply to all industries on matters such as misleading or deceptive advertising), the medium which may be used and the time at which advertisements may be broadcast also impose deadweight losses for similar reasons;
- restrictions on advertising are likely to bias the form of advertising. A ban on brand advertising, for example, could be expected to result in more sponsorship advertising. Similarly, a ban on brand advertising on television would be likely to lead to more advertising on radio and in the print media. Another example would be the promotion of products indirectly through agreements with the producers of television programmes to display products in their television programmes. Thus unless advertising restrictions are extensive, their main effect is likely to be a decrease in the efficiency of advertising expenditure rather than a large reduction in consumption of the relevant product;
- brand advertising promotes the reputation of producers and distributors. They have incentives to enhance their reputations, and their long-term interests are damaged by the association of their products with misuse such as the commission of crimes. To the extent that restrictions on advertising inhibit the promotion of the reputations of producers and distributors, they will impair the incentives of producers and distributors to discourage the misuse of their products;
- advertising bans, by lowering the non-quality-adjusted price of the product, may actually increase consumption of the product concerned by a small amount, thereby biasing consumer choice. In addition, bans may prohibit anti-drinking publicity or the promotion of moderate drinking, thereby contributing to higher demand than otherwise. Finally, advertising bans may make it more costly to introduce new brands, such as low-strength alcohol, thereby adding to consumption. Similar findings were reported by Schneider, Klein and Murphy (1981) in respect of cigarette advertising;<sup>22</sup> and
- while consumers do not face the costs of subsidised public health services (other than indirectly through excise taxes), controls on advertising are an inefficient way of addressing this issue because, for example, they do not impose the marginal alcohol-induced health costs on consumers.

<sup>21</sup> The reputation of the distributor rather than that of the producer is emphasised with no frills products. The limited size of the no frills market relative to that for comparable branded products illustrates the importance to consumers of advertising and similar expenditure.

<sup>22</sup> Schneider, Klein and Murphy (1981) rejected previous research findings which had indicated that advertising bans had been effective in reducing demand. In their view earlier studies had been based on mis-specified econometric equations.

Private individuals and groups who wish to promote lawfully the prohibition of liquor or its moderate use should be able to do so using their own resources. As Gray (1992) concluded:

The danger [to society] comes, not from advocacy advertising, but from restrictions on advertising which have the same goals as some of the advocacy groups ... who pursue these goals via restrictive regulation and prohibition rather than by persuasive communications.

For these reasons we believe a sceptical view should be taken of industry-specific advertising restrictions. The same view is appropriate in respect of self-regulation which is motivated in large part by the desire to avoid statutory regulation. The evidence indicates that such restrictions harm consumers. Controls on advertising focus on restricting liquor consumption rather than addressing abuse. They cannot be justified on economic grounds and should be abolished.

## 6 HEALTH WARNINGS

The assumption that consumers are poorly informed on the health risks of liquor underlies the argument for mandatory health warnings on labels and in advertisements. Consumers are said to underestimate such risks, and this leads to excessive consumption of liquor from the community's viewpoint.

There are strong grounds for being sceptical of the view that consumers are misinformed on the risks that they face. As Fischhoff *et al.* (1981) noted:

Risk is an ever-present aspect of life, and its management occupies a prominent position among society's concerns.

Health risks associated with the consumption of liquor are but one risk which consumers face every day. In economic models, utility maximising consumers are postulated to trade off the possibility of some small detrimental effect on their health against the benefits from the consumption of goods and services that involve those risks. Thus Woodfield (1985) wrote:

Moderate drinkers willingly accept a small amount of risk in order to enjoy the ... benefits associated with alcohol use. If that risk did not exist, they would probably drink more alcohol. An important implication of this argument is that willingly-accepted health risks associated with drinking are internalised in the measurement of consumer surplus, the estimate of which would be smaller, the greater the perceived health risk.

The same is true for those consumers who consume more, or less, than a moderate amount of liquor. Furthermore, individual consumers may be willing to bear different amounts of risk. There are no valid grounds for arguing that public policy should be predicated on the view that risk averse behaviour is more efficient or desirable than other aptitudes for risk (Demsetz 1969).

The next question is whether it is valid to assume that consumers are uninformed about the level of health risks associated with the consumption of liquor. Consumers have incentives to acquire information on the risks which they face up to the point where the marginal benefit of acquiring information equals the marginal cost involved in its production and dissemination. Because information is costly to

obtain and analyse, research aimed at seeking 'complete' or 'perfect' information would be uneconomic (Demsetz 1969).<sup>23</sup>

Producers also have incentives to provide information on the safety of their products and could be expected to do so if it were beneficial to consumers (for example, where it is cheaper for the producer rather than the consumer to provide the information). Information provided may be of a general nature, such as that conveyed by the reputation of the producer (for instance, by a particular brand). It may also include detailed information on health risks such as that which is available from health professionals (among other sources).

There are also empirical reasons for being sceptical of the view that drinkers systematically underestimate the risks involved. Individuals have generally been found to be informed on most risks that they face. Peltzman (1975) showed that the use of motor car seat belts was consistent with rational maximising behaviour. In an experiment related to the information content of hazard warnings, Viscusi and O'Connor (1987) found that chemical plant workers responded largely as expected to new information on the risks which they faced (that is, their turnover rate increased and they sought higher wages in response to larger risks). Furthermore, Viscusi, Magat and Huber (1987) examined the rationality of consumer valuations of multiple health risks. Their results bore out "many of the most salient predictions of economic theory."<sup>24</sup>

Consumers' response to information on the health risks associated with smoking are perhaps most closely related to those of liquor. Becker and Murphy (1988) commented as follows:

The information that began to become available in the late 1950s on the relation between smoking and health provides an excellent experiment on whether persons addicted to smoking consider the delayed harmful consequences or whether, instead, they are myopic. Ippolito, Murphy, and Saint ... estimate that 11 years after the first Surgeon General's report on smoking in 1964, per capita consumption of cigarettes and of tar and nicotine had been reduced by 34 percent and 45 percent respectively.

In the view of Becker and Murphy:

This evidence blatantly contradicts the view that the majority of smokers were myopic and would not respond to information about future consequences because they discount the future heavily.

Subsequent research reinforces this conclusion. Viscusi (1990) found that both smokers and non-smokers greatly overestimate the lung cancer risk of cigarette smoking, and that the extent of overestimation was much greater than the extent of underestimation.<sup>25</sup> Furthermore, Viscusi (1995) notes that:

People overestimate small identified risks, whereas they often ignore small unidentified risks. People also tend to underestimate the large risks that have the greatest consequence. Publicity has a distorting rather than an informative role as people tend to overestimate highly publicised risks as well as those

<sup>23</sup> Grant (1985) makes the common mistake of dismissing economic analysis on the grounds that consumers do not have perfect information.

<sup>24</sup> Contradictory evidence relates to an apparent under-insurance of low probability but potentially high cost events such as possible loss from earthquakes and floods – see Viscusi (1992). Health risks do not fit into this category. For a discussion of the relevant research and possible explanations see New Zealand Business Roundtable (1989).

<sup>25</sup> That is, the distribution of respondents was biased toward overestimation.

risks with which they have had recent experience. More generally, people display limited cognitive ability to process information.

Both theoretical and empirical analyses suggest that the grounds for believing that consumers systematically underestimate the risks to their health from consuming liquor are dubious. The arguments that consumers are poorly informed or are myopic often seem to reflect a paternalistic view (Castle 1986). These findings suggest that the grounds for requiring mandatory health warnings on liquor labels and in advertisements are weak.

The inclusion of a mandatory health warning about the consumption of liquor during pregnancy on all liquor labels would be a cost ineffective means of conveying information to the target population. Similarly, it is implausible that many drinkers are unaware that consumption of liquor may impair their capacity to drive or operate machinery. The suggestion that consumers be warned that liquor can "increase the risk of developing hypertension, liver disease and cancer" is potentially misleading if the protective effects of moderate consumption noted above were not also included.

There may, at most, be a valid case for the government to provide information to the public on the health risks associated with the misuse of liquor on the presumption that consumers are misinformed. The government would in effect subsidise the cost of acquiring information. Any information should be targeted at people who are likely to benefit. The government has programmes along these lines in place.

## 7 EXCISE TAXES

Liquor, tobacco and certain petroleum fuels are the only products still subject to excise taxes.<sup>26</sup> Excise duties on beer, wine and spirits are forecast to raise \$452 million, or 1.4 percent of total tax revenue, in 1996/97. Excise tax accounts for about 20, 30 and 50 percent of the retail price of certain representative beer, wine and spirit products respectively.<sup>27</sup>

There are no economic grounds for levying excise taxes on beer, wine and spirits where the consumer is of sound mind and is capable of making rational decisions, bears the full costs of his or her actions, and is aware of the risks and benefits involved. In these circumstances, excise duties are inconsistent with standard efficiency and equity criteria.

The social cost argument for excise taxes is dubious. Most costs that arise from the consumption of liquor are met by the affected consumer and the household unit, not by other members of society. The consumer bears the adverse effect on his or her productivity (for example, through lower wages and impaired promotion prospects) and many costs associated with alcohol-related accidents and illnesses (through insurance premiums and the loss of enjoyment of life) and anti-social behaviour (fines and other penalties).

The main categories of costs that are not fully imposed on the consumer arise from the provision of most health services free of charge, from some aspects of the Accident Rehabilitation and Compensation Insurance Corporation (ACC) scheme and from the criminal justice system which does not permit victims to be compensated fully by offenders. The government could take action to place the

<sup>26</sup> To the extent that excise tax on petroleum products is used to finance roading expenditure it should be examined as a user-charge.

<sup>27</sup> Quay Group (1995a).



costs more directly on those responsible for generating them. The relevant policies, however, are not specific to costs arising from the consumption of liquor.

If these policies are retained in respect of other activities, it is unlikely that a more economically efficient outcome can be achieved by applying selective taxes to consumers of liquor alone. Even if this approach were adopted, a substantial reduction in taxes would be justified. The costs of health care and accidents that relate to the use of beer, wine and spirits would not warrant the present levels of duty.

Excise taxes are an inappropriate means of attributing social costs to users. They affect all consumers of beer, wine and spirits rather than people who engage in anti-social behaviour only. Would it be sensible to impose excise taxes on ammunition because some shooters are involved in accidents?

Excise duty subjects significant numbers of members of low and moderate income households who consume beer, wines and spirits to higher levels of total taxation than households with members on comparable incomes who do not consume such products. Similarly, households with members who drink liquor and earn similar incomes pay varying amounts of total tax depending on the level of their consumption. These outcomes are inconsistent with the principle of horizontal equity which states that households in like situations should pay the same amount of total tax.

Since 1984 tax reforms have removed or reduced most highly distorting taxes. Excise duties on beer, wine and spirits have not yet been addressed although the government has accepted as a principle that only GST should apply to these products. Selective taxation is likely to be an inefficient method of raising revenue relative to broad-based taxes at a uniform rate because it distorts the patterns of trade and personal consumption. It creates unintended anomalies as technology and tastes change. It penalises groups in society, often unintentionally, and sometimes as a result of attempting to relieve the burden on someone else.

Excise tax on liquor needs to be addressed on a first principles basis in establishing an efficient regulatory framework for the supply and consumption of liquor. The Advisory Committee should recommend that the government undertakes such a review.

## 8 CONCLUSIONS AND RECOMMENDATIONS

The thrust of this submission is that the regulatory framework for the supply and consumption of liquor should be brought into conformity with that of other products, except where there are valid public policy grounds for industry-specific interventions. Many other products or activities involve risks and the possibility of abuse, yet are not subject to anything like the degree of control and punitive taxation as liquor.

People derive substantial benefits from the consumption of liquor. The vast majority of users act responsibly. Policies that target the misuse of liquor rather than responsible consumption are required to address anti-social behaviour.

The prime responsibility for encouraging young people to use liquor appropriately rests with their parents. The government's main roles are to establish and enforce laws which uphold the rights of all citizens and to fund health programmes that treat alcohol abuse. Industry participants have an important duty to foster responsible attitudes to drinking and to comply with the liquor laws.

Most present regulatory interventions focus on the control of the supply of liquor. This approach was correctly rejected by the Laking working party and has been further discredited since its report was completed. The primary focus of the Advisory Committee should be to recommend rules that help to bring the drinking decisions of young people into conformity with the wishes of their parents and guardians. If such rules are to be credible, they will need to command wide support within the community, and be practicable and properly enforced. Most industry-specific regulations are not required for the achievement of these objectives, and the Committee should propose their abolition.

The NZBR recommends that the Advisory Committee adopt the following proposals:

- that young people who are supervised by a parent or guardian should generally be able to buy and consume liquor;
- that the minimum age at which young people can buy and consume liquor without parental consent should be reduced to between 16 and 18 years;
- that liquor licensing be abolished to facilitate open competition among firms;
- that traders be permitted to establish the days and hours of business. If this recommendation is not accepted then it is recommended that the sale of liquor be made subject to the Shop Trading Hours Repeal Act 1990;
- that industry-specific controls on liquor advertising be abolished;
- that the inclusion of mandatory health warnings on liquor labels and liquor advertisements be opposed; and
- that the government undertakes a first principles review of excise tax on liquor.

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**SUBMISSION BY THE  
NEW ZEALAND BUSINESS ROUNDTABLE**

**ON THE**

**WORKING GROUP ON CO<sub>2</sub> POLICY'S  
DISCUSSION DOCUMENT**

***CLIMATE CHANGE AND CO<sub>2</sub> POLICY***

**OCTOBER 1996**



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## EXECUTIVE SUMMARY

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- 1 This submission on the working group on CO<sub>2</sub> policy's June 1996 discussion document *Climate Change and CO<sub>2</sub> Policy* (the discussion document) is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The NZBR's purpose is to contribute to the development of sound public policies that reflect overall New Zealand interests.
- 2 The NZBR's longstanding views on this issue and the difficulties we see with the government's approach to date are summarised in section 2. Briefly, we do not see that the case has yet been made that New Zealanders would incur negative net benefits from projected global warming and, in the absence of effective action internationally, it could be much cheaper for New Zealand to adapt to projected climate change than to attempt to reduce its own net emissions. The discussion document tends to reinforce our concerns on both these points.
- 3 Nothing in this view would preclude New Zealand from playing its part in effective international action, but this would involve negotiations in which those countries that have most to gain trade with those which would need to be compensated for losses. New Zealand needs to have a clear view of where the interests of its residents lie when entering such negotiations.
- 4 We fully support the minister for the environment's objective, expressed in his covering letter to the discussion document, for New Zealand to have a well thought-out policy position which is understood domestically. However, we think that the government's policy goal of a fixed quantity target by the year 2000 and its willingness to impose a unilateral carbon charge by 1997 create major difficulties in respect of the minister's objective. A list of the problems which we see with the premises that appear to underlie current government policies is provided in paragraph 2.10 below. Sections 2, 3.1 and 4 comment further on the difficulties with the goal for net emissions by the year 2000.
- 5 Considering the key issues which the government identified in the working group's terms of reference, we agree with a national policy approach rather than a consent-specific approach in accordance with the Resource Management Act 1991. We also agree in principle with a net emissions approach based on carbon sinks. We do not agree with quantity targets which are independent of the rate of economic growth and therefore insensitive to cost/benefit considerations. We do not agree that a carbon charge in 1997 is necessary, desirable or efficient, either from a welfare maximisation perspective based on environmental considerations or from the point of view of international politics (refer to section 3.2 and section 4).
- 6 We respond to the working group's conclusions in section 4. Briefly, we agree with many of them. Points of disagreement concern the inadequate justification provided by the Framework Convention on Climate Change (FCCC) (apparently taken as a given by the working party) for excluding Annex II countries and the unsatisfactory nature of the case for moving unilaterally to a carbon charge.
- 7 In our view the government should not make any decisions now about either the tax or the permit option because the fundamental case for policy action has not been made out. The choice between carbon taxes and tradeable permits is not a straightforward one. Abstracting from many practical realities, the two are

economically identical. The choice between them, therefore, is not a major issue from a high level viewpoint; it comes down to a careful examination of their finer features in practice. We suspect that more work needs to be done on this question by those who are most aware of the practical difficulties which could arise.

- 8 Section 5 comments on four more technical points in relation to the discussion document. First, while we favour broad-based rather than non-uniform taxes as a general rule, the discussion document does not consider the possible case for differential charges based on the international mobility of affected industries when other countries have diverse effective tax rates. Secondly, we think that there are difficulties in terms of economic efficiency with any impost applied in sunk cost situations. Thirdly, we would be less confident than the working group that petrol excise taxes will rise rather than fall in the long term, given the likely eventual introduction of direct electronic billing of motorists. Fourthly, we do not think that the discussion document adequately discusses the economic costs of the measures considered.
- 9 Section 6 presents our concluding comments. Having ratified the FCCC, New Zealand must continue to address two potentially conflicting objectives – the objective of being seen to 'play our part' internationally and the objective of maximising the welfare of New Zealand citizens.
- 10 In the absence of any convincing case that uncompensated-for measures to reduce net emissions would improve the welfare of current or future New Zealand citizens, the case for any action must primarily rely on a political economy assessment of international reactions to alternative policy decisions by New Zealand. Since neither the United States nor Australia is contemplating a unilateral carbon charge (and many Asian and other countries have made it clear that they have no intention of taking measures which would harm their economies), it is hard to see what that case might be.
- 11 In our view, the government faces considerable difficulties in providing a robust justification for any proposition that real economic costs should be incurred in the pursuit of its target for the year 2000. In particular, the imposition of a low-level carbon charge, whether through a tax, a permit system or a hybrid, lacks credibility as a soundly based response to the problem.

## 1 INTRODUCTION

- 1.1 This submission on the Working Group on CO<sub>2</sub> Policy's June 1996 discussion document *Climate Change and CO<sub>2</sub> Policy* (the discussion document) is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The NZBR's purpose is to contribute to the development of sound public policies that reflect overall New Zealand interests. The NZBR's longstanding interest in New Zealand's CO<sub>2</sub> policy is summarised in section 2.
- 1.2 We applaud the minister for the environment's desire to have a well thought-out policy position which is understood domestically. It is also desirable that New Zealand is able to make a high quality contribution to debate at the international level. In this submission we concentrate on the progress being made towards the first of these objectives – a sound domestic policy. Comments on how New Zealand can contribute to the second objective are included in earlier NZBR material referred to in section 2.
- 1.3 Section 2 also sets out the NZBR's overall views about what would constitute a sound public policy position. A key conclusion here is that policy should be driven by the need to relate costs to benefits, rather than by the need to pursue essentially arbitrary short-term quantity targets which bear no obvious relationship to assessed benefits.
- 1.4 The following sections of the submission apply this perspective to the issues which the government placed in front of the working group. We broadly follow the format set for the working group in its terms of reference – government objectives, key issues, conclusions on its tasks and methodology.
- 1.5 Section 3 comments on the government's statement of policy objectives and the key issues laid out for the working group.
- 1.6 Section 4 responds to the working group's conclusions as summarised on page 9 of the discussion document. The terms of reference also specified the working group's main tasks and provided some guidelines on the methodology the working group was to employ. Some comments of a more technical nature on the methodology are provided in section 5. Section 6 presents our concluding comments.

## 2 BACKGROUND: THE NZBR'S APPROACH TO GLOBAL WARMING ISSUES

- 2.1 In this section we summarise the NZBR's contributions and views on the public policy issues raised by the threat of global warming.
- 2.2 In May 1991 we made a submission on the Ministry for the Environment's discussion paper *Developing a Strategy to Reduce CO<sub>2</sub> Emissions: A Scoping Paper*. In this submission we argued *inter alia* that:
- there was "insufficient evidence to determine whether New Zealand would on average gain or lose from the greenhouse effect";
  - any warming would be so gradual that adaptation can occur over time;

- unilateral action by New Zealand would be pointless;
- in international forums, New Zealand can already point to significant policy actions which are compatible with the mitigation of greenhouse effects; and
- New Zealand should suspend its commitment to a reduction in CO<sub>2</sub> emissions pending:
  - clearer scientific evidence,
  - greater evidence of concerted and concrete international action,
  - a proper cost-benefit analysis of the likely effects of New Zealand action.

- 2.3 Our views on these issues have not changed. The fact that New Zealand has subsequently ratified the Framework Convention for Climate Change (the FCCC) no doubt increases the political costs of adopting our suggested approach but, as events in Australia are revealing, international commitments made in advance of any clear acceptance by the community of the case for bearing the subsequent costs do not avoid the need to demonstrate that such costs are warranted.
- 2.4 In April 1994 we made a submission to the Ministry for the Environment on its consultation document *Exploring the Options for Reducing Net Emissions of Carbon Dioxide*. This submission made similar points, while supporting a 'no regrets' net emissions approach domestically. The submission identified a range of policies which should be explored under a 'no-regrets' approach.
- 2.5 On 13 May 1996 we responded to a request from the Ministry of Foreign Affairs and Trade for views on the focus for New Zealand's efforts at the July 1996 Ad Hoc Group on the Berlin Mandate (AGBM) meeting. We supported the thrust for price equalisation rather than country quantity targets. Again we stressed the need for policies to be focused on relating benefits to costs and the importance of distinguishing between measures designed to address political objectives in international forums and measures designed to address a potential underlying economic/environmental problem.
- 2.6 Considerable uncertainties exist about the likely climatic effects of the build-up in greenhouse gases in the upper atmosphere, although there is a well-accepted basis for expecting some warming to occur. Some experts have expressed disquiet about the process being used to generate summary statements of the scientific consensus for policy makers by the Intergovernmental Panel on Climate Change (IPCC). Material changes have been made to the models used to predict climatic effects since the first IPCC predictions, with the result that earlier forecasts of the extent of warming have been scaled back and the timetable pushed out. It would seem prudent to anticipate further substantial revisions in the years ahead as new information emerges. Given the complexity of the factors affecting the global climate, the inevitable over-simplification of formal models and the lack of prolonged experience with forecasting human-induced climate change, we are sceptical of the claim apparently endorsed on page 25 of the discussion document that the models provide a reliable indication of the scale of climate change for the next 50 years.
- 2.7 In 1995 and 1996 we also sought to promote public awareness of the nature of the criticisms of the 'consensus view' from leading scientists by bringing to New Zealand two critics whose expertise in this area is beyond dispute.

The following summarises our current views on the public policy issues:

- (a) the government's greenhouse gas policies should aim to maximise the welfare of current and future New Zealand citizens;<sup>1</sup>
- (b) the projected global climate change to the year 2100 could have beneficial as well as harmful effects on the welfare of New Zealand citizens, and no convincing case has been made that the overall net effect would be negative;<sup>2</sup>
- (c) the projected climate change is highly uncertain, but is likely to be so gradual that adaptation over time is feasible;
- (d) in any case, unilateral action by New Zealand to reduce net emissions would impose real resource costs, but not affect climate change projections;<sup>3</sup>
- (e) there is little evidence to indicate that Annex I (developed) or Annex II (developing) countries are willing to implement costly measures in order to reduce their net emissions;<sup>4</sup>
- (f) carbon taxes, tradeable permits and/or mandatory energy efficiency standards would impose real costs on New Zealanders with no discernible climate change benefits;
- (g) price equalisation measures, if politically achievable, are likely to be much more efficient in reducing global net emissions than country quantity targets;
- (h) if and when countries which see themselves as losers from projected climate change enter international negotiations in order to induce other countries to take corrective action when it may not be in the interests of their citizens to do so, the New Zealand government should be prepared to negotiate in the best interests of New Zealand citizens;
- (i) the objective of being seen to 'play our part' in the international community should be analysed in cost-benefit terms based on an explicit assessment of the likely international repercussions from the adoption of alternative

<sup>1</sup> This will take into account their desire to help others, such as residents of low-lying Pacific Island countries.

<sup>2</sup> The discussion document itself concludes, on p. 26, that it is not yet known if the net effects of climate change on New Zealand would be positive or negative.

<sup>3</sup> The working group also appears to support this approach. For example, on p. 83 the discussion document makes it clear that the timing of the use of any economic instrument should be related to the timing of moves by other countries to increase the price of carbon on a comparable basis.

<sup>4</sup> For example, p. 67 of the discussion document comments that "There is no immediate prospect of developing countries taking on commitments to significantly limit emissions". Although the document finds that broad-based economic instruments are likely to be most efficient in reducing CO<sub>2</sub> growth, the discussion on pp. 31–32 provides no indication of any expectation that Annex I countries are likely to adopt tradeable permits or new carbon taxes. It notes that five countries already have carbon taxes in place (forty-one countries are listed as Annex I countries on p. 142 of the document), but does not indicate that any of these are moving to strengthen these taxes, for example by removing industry exemptions.

approaches.<sup>5</sup> It seems unlikely that the pursuit of this objective would warrant the imposition of a carbon charge in 1997; and

- (j) New Zealand should continue to research this issue and develop its options. From an environmental perspective it should focus on net emissions of all greenhouse gases including methane, which seems to have been excluded from policy considerations to date largely for political reasons (a desire not to antagonise farmers). Australia and the United States have a zero target for net emissions of all greenhouse gases.<sup>6</sup>

2.8 Common ground between these views and government policy includes support for further research, the adoption of a net emissions approach and the promotion of a price-equalisation strategy across countries. Until the government's July 1994 measures were announced, the NZBR believed that the government was fully aware of the pointlessness of taking measures which simply saw industries or firms migrate to other countries for no environmental benefits. The decision in respect of a carbon tax in 1997 appears to indicate, however, a determination that New Zealand should act unilaterally.

2.9 As explained in the foreword to the discussion document, the government's aim in instructing the working group to review how New Zealand can best meet its twin objectives was to see that the developing climate change debate is addressed responsibly. The foreword comments that:

For too long, ill-informed and polarised views have dominated public debate on this important issue. A better-informed debate is essential if we are to tackle the issue rationally; and

It is vital that New Zealand has a well thought-out policy which is understood domestically and is able to make a high quality contribution to debate in international fora.

2.10 The NZBR's contributions to date have been directed at the objective of better-informed debate based on well-thought out and widely understood policies. In our view, this is not a debate between industry and environmental interests; rather it is a debate about what policies would maximise the welfare of New Zealand citizens. We agree that there is a need for better analysis and debate. For example, in our view the government has so far failed to convince the commercial community that it has a sound rationale for the following propositions which appear to underlie its policies:

- (a) that the costs to New Zealand from projected climate change exceed the benefits;
- (b) that any real economic costs imposed on New Zealanders by attempting to reduce net greenhouse gas emissions will produce benefits in terms of reduced global warming which are commensurate with the costs;
- (c) that the benefits to New Zealand from the government's decision to ratify the FCCC in 1993 are other than political;

<sup>5</sup> Help for low-lying Pacific Island nations may be best met, for example, by commitments to open immigration policies, should the need arise.

<sup>6</sup> Refer to table 2.4a, p. 31 in the discussion document. Australia also has a -20% target for 1988-2005.

- (d) that the benefits to New Zealand from the government's decision to enter into commitments under the FCCC exceed the costs;
- (e) that third world countries draw no benefit from the developed world's enormous investments in the last two hundred years in technology and knowledge so that all the costs of reducing atmospheric greenhouse gases should, as a matter of equity, fall on Annex I countries;
- (f) that any such inter-country equity issues are better dealt with by inefficient policies which encourage the growth of emitting activities in Annex II countries, rather than by more efficient policies which avoid this effect, supplemented by direct wealth transfers if necessary;
- (g) that there is any justification for New Zealand's decisions to move away from a 'no-regrets' policy to the point where the government has committed itself to introducing a low-level carbon charge in December 1997, regardless of the actions of other countries and regardless of the fact that such action would have no material impact on global climate change;
- (h) that it is better for New Zealand to devote resources to prevention rather than adjustment;
- (j) that it is efficient for New Zealand to focus initially on CO<sub>2</sub>-reducing measures rather than on greenhouse gas-reducing measures generally; and
- (j) that stabilising net emissions by the year 2000 is desirable or achievable.

The following paragraphs elaborate on some of these propositions.

- 2.11 Paragraph 2.1.6 of the discussion document comments on the predicted effects of projected global warming on New Zealand. From a consumer welfare perspective, the comments are preliminary, incomplete and arguably one-sided in places. For example, the reference on page 26 to possible effects on human health speculates solely about malaria. No doubt it is fair to suggest that higher temperatures would increase the incidence of heat-related illnesses and human discomfort. But would not an even-handed approach balance this against the possibility of a reduction in the incidence of cold-related diseases and human discomfort? Winter flu and deaths from hypothermia undoubtedly reduce well-being in New Zealand at present, yet the effect of a warmer climate on winter influenza and on reduced human discomfort from cold is given no consideration in the discussion document. In contrast, malaria is not a problem in this country. Further, using the rule of thumb provided in section 2.1.6 of the discussion document, projected global warming of 2° C for the next hundred years would be equivalent in temperature terms to moving New Zealand 200–400 kilometres closer to the equator. Auckland is 350 kilometres south of Kaitaia. Kaitaia has no malaria problem. What could therefore warrant focusing the reader's attention on the possible effects of global warming on the incidence of malaria in New Zealand?
- 2.12 Another illustration of incomplete discussion from a consumer welfare perspective is the absence of any acknowledgment that warmer average temperatures in New Zealand should reduce the annual heating bill, since New Zealanders currently spend much more on fuel for winter heating than on fuel for summer air conditioning. Building costs might also be reduced. Nor is there any consideration of the possibility that the productivity of some land might



be improved by a warmer average climate. The only possible effects on the productivity of land and horticulture which were mentioned were all negative.

- 2.13 Some of the discussion in this section relates to the costs of adapting to climate change. But the pace of climate change is surely very slow relative to the rate of change in productive land use which arises from conventional economic forces. Consider, for example, the marked switches in land use in past decades between deer, dairy, sheep and beef farming, livestock and forestry, and grapes, kiwifruit and other crops.
- 2.14 Even so, the discussion document drew the following conclusion from this limited and one-sided discussion:

It is not yet known whether the net effects of climate change will be positive or negative for New Zealand. However, the transitional costs of adjusting to variations in current climate conditions are likely to be significant.

The comment on transitional costs is unconvincing for the reasons just noted. Putting this point to one side, we believe New Zealand would do better to focus its efforts on considering measures likely to reduce adjustment costs rather than impose real costs on itself in the hope of influencing the international community to take corrective action (refer to point 2.10 (h) above).

- 2.15 More fundamentally, the admission that the net effects of climate change are not necessarily negative for New Zealand illustrates the difficulties that politicians would face in explaining why current voters must incur higher heating and transport bills because of global warming projections. To the argument that these policies are to prevent their great-great-grandchildren from experiencing marginally warmer average temperatures, today's voters may reasonably respond that (a) New Zealand's actions cannot possibly affect global warming so the claim is spurious; (b) their descendants are likely to live in cities and to prefer moderately warmer temperatures; and (c) future technologies are likely to be so much superior to current technologies that wasteful emissions will be much reduced, along with the costs of adapting to any climate changes.
- 2.16 To the argument that these costs need to be imposed because other countries may be adversely affected, they might reply in a similar vein in respect of point (a) in 2.15 above; ask why many other countries are not imposing carbon charges; suggest that those countries which want us to change for their benefit should pay for our adjustments; and suggest that offering immigration rights to refugees from low-lying Pacific Island nations should the need arise might be a much more practical and efficacious form of assistance.
- 2.17 We make these points because we have been critical of recent ministerial statements which present the debate about CO<sub>2</sub> policy as one in which government policy stands on the middle ground between extreme and unhelpful 'environmental' and 'industry' views. Such a comment, in our view, only serves to distract attention from the real policy issue – the degree to which government policy is consistent with welfare maximisation.
- 2.18 Regrettably, current policy appears to be driven by an inevitably politicised international process which sees unsoundly based commitments being made by parties which have very little idea of their potential costs, limited ability to muster the political will to impose significant costs on their home communities,

and minimal interest in the effects of their actions on the welfare of New Zealanders.<sup>7</sup>

- 2.19 New Zealand advisers and decision makers initially thought that the goal for the year 2000 could be met by New Zealand without cost. Revisions to base year estimates and stronger than expected economic growth have demonstrated the risks involved in making commitments which lack a sound fundamental basis.
- 2.20 Now that the government is approaching the point at which it is contemplating making all New Zealanders pay more for heating fuel, electricity and transport, and is putting in place policies which are likely to promote changes in land use and the migration of some emitting activities to other countries, it must explain to New Zealanders why such policies are in their interests. In our view, presenting this as an industry-versus-environmental issue does nothing to clarify or advance the public policy debate.

### 3 THE GOVERNMENT'S POLICY OBJECTIVES AND KEY ISSUES

#### 3.1 Policy Objectives

3.1.1 The government's key policy objectives, as conveyed to the working group in its terms of reference, are to:

- stabilise net CO<sub>2</sub> emissions at 1990 levels by the year 2000; and
- minimise the impact and risks of CO<sub>2</sub> policy measures on output and growth in the economy.

Further, its key economic policy objective is to maintain and enhance economic growth.

- 3.1.2 The discussion in section 2 raised some of the difficulties of explaining how an arbitrary quantity target for the year 2000 might be consistent with welfare maximisation.
- 3.1.3 As the discussion document notes in sections 6.13 and 7.2, the costs to New Zealand of pursuing these objectives is likely to depend on the extent to which other countries act in unison with New Zealand. If they do not, New Zealand may be able to meet its quantity target at relatively low cost provided emitting industries can readily migrate to other countries.
- 3.1.4 In a situation where the recipient country is not imposing a similar impost on emissions, the migration of activities may not be associated with any reduction in global emissions. This would not be a problem if the government's statement of its objectives (see paragraph 3.1.1) is complete. However, the discussion document also considers the possibility that the government would rather achieve

<sup>7</sup> Consider for example, the following ascerbic comment from *The Economist*, 19 March 1994:

... [s]ome see all this [the FCCC] as inspiring proof of a new commitment to saving the environment. In fact, it merely shows how easy it is for politicians to sign bits of paper – so long as they will be safely in retirement when the time comes to take action. ... When the industrial countries start to consider seriously ways to reduce their output of greenhouse gases, they will ask some awkward questions. They will want clearer scientific evidence that the accumulation of greenhouse gases really changes the climate and, if so, whether the change carries appreciable economic costs.

its objectives with a greater rather than a smaller impact on global net emissions. This supplementary objective might make it optimal for New Zealand to set a lower quantity target, the lower the effective rate of tax on emissions in countries to which emitting activities might migrate. Alternatively, it might make it optimal to tax at a lower rate activities which are most likely to migrate to countries with lower effective rates of tax, with no benefit in terms of global emissions. The implications of such alternative objectives for the optimality of a broad-based impost on carbon emissions are discussed in section 5.1 below.

3.1.5 A further difficulty with the government's stated objective is that it does not look achievable under current projections, even if a low-level carbon charge is introduced in 1997. This issue is discussed in greater detail at the end of section 4. Indeed, if a low-level charge in conjunction with the political instability introduced by a mixed member proportional parliament creates a risk in people's minds that the charge could be markedly increased in the future, there would be an incentive to increase current consumption of fossil fuels relative to future consumption because they will never be cheaper.<sup>8</sup>

3.1.6 However, in our view the biggest difficulty caused by the government's statement of objectives is that the arbitrary quantity objective distracts attention from the need to relate costs to benefits. This colours the analysis in the discussion document which favours a cost minimisation approach regardless of benefits.

## 3.2 Key Issues

3.2.1 The terms of reference for the working group also include three key issues to be considered by the government:

- the choice between a national policy and a consent-specific approach;
- how best to address forestry issues and the sensitivity of the net approach to gross domestic product (GDP) projections; and
- the efficiency of a possible carbon change.

3.2.2 On the first issue, we agree that a national approach is preferable to a consent-specific approach. The economic analysis leading to the Stratford combined cycle decision was woefully inadequate. It is undesirable to tax relatively efficient activities but not relatively inefficient ones.

3.2.3 To the degree that the policy objective is to reduce net emissions for environmental reasons (rather than to ensure New Zealand is seen to be 'playing a part' internationally), we agree that policy should, in principle, focus on net emissions. Therefore absorption through forestry is relevant. The practicality of a net approach is a proper matter for debate. The sensitivity of current policy to GDP growth projections simply serves to highlight the inadequacy of a policy objective which fails to relate marginal benefits to marginal costs.

3.2.4 On the third issue, it appears that the government's year 2000 objective is unachievable on current projections with any practicable carbon charge. It would also be inefficient from a consumer welfare perspective since it would impose

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<sup>8</sup> This possibility is belatedly acknowledged in the discussion document in section 7.4.2. Of course the overall rate of depletion of fossil fuels should fall even if future consumption (including exports) were tilted towards the present.

economic costs for no or inconsequential environmental benefits. The issue of whether it would produce greater net benefits in terms of international relations than alternative approaches was not part of the working group's terms of reference, and no such case has been made. The fundamental problem here lies with the government's policy objective.

#### 4 COMMENTS ON THE WORKING GROUP'S CONCLUSIONS

- 4.1 In respect of the working group's 11 numbered conclusions on page 9 of the discussion document, we agree with numbers 1, 2, 3 and 8 and broadly agree with numbers 5 and 6.
- 4.2 However, in respect of conclusion 3 we draw no inference that, because economic instruments have a potentially powerful influence on the path of net emissions, the government would therefore be justified in using them to move further towards its existing policy targets.
- 4.3 While we generally support the case for broad-based, low-level taxes, the discussion document does not discuss as carefully as it might the optimality of non-uniform taxes when activities differ in the ease with which they can migrate across national borders and when effective rates of tax vary markedly across countries. In section 5.1 below we consider the case for differential rates of tax in such a situation.
- 4.4 While supporting the cross-country price-equalisation approach in conclusion 5, we do not agree that New Zealand should accept, in principle, any case in terms of efficiency or equity for excluding Annex II countries from this approach. Equity issues are of course relevant to negotiations over the terms under which countries agree to participate.
- 4.5 In respect of conclusions 7, 9, and 10, we do not agree that there is an adequate case for the government endorsing, for the foreseeable future, either a carbon tax at any level or a transferable carbon charge scheme. Our disagreement here is not so much with the working group's analysis (although we see the need for more discussion of the 'playing our role' issue), as with the government's policy objectives which the working group had to take as given in its terms of reference (see sections 2 and 3.1). We welcome the recognition in conclusion 9 that any decision made by the year 2000 on the settings and timing of instruments should be conditional on measures taken by other countries.
- 4.6 We agree with conclusion 11 that a nationally legislated economic instrument would remove the need for CO<sub>2</sub> consents under the Resource Management Act 1991, but do not see this as a necessary or desirable means of achieving this worthwhile objective.
- 4.7 One of the working group's key tasks, according to its terms of reference, was to assess the costs and benefits of alternative economic instruments and other measures for achieving the government's CO<sub>2</sub> policy objectives. The working group's conclusions do not contain an explicit answer to this question. Table 7.3.2a presents some results, one of which is that a \$100 per tonne carbon charge would, in the model used, stabilise net emissions at 1990 levels by the year 2000. This charge would need to rise to \$250 per tonne by the year 2010.

- 4.8 The discussion in section 7.3.3 about the costs of such a policy suggests that it would reduce the growth rate of real GDP by 0.08 percent per annum initially, rising to 0.67 percent per annum by the years 2010–2020. While this calculation is relevant to the question asked of the working group about the effects of policies on New Zealand's growth rate (if this is interpreted as the growth in real GDP), it is not a calculation which is clearly related to economic cost considerations (see section 5.4 for some discussion of economic cost concepts). Further, national income is a better measure of income accruing to New Zealanders than GDP, but all such measures have serious limitations as indicators of the costs to the community of reallocating resources in response to a change in relative prices.
- 4.9 The key point here in respect of the government's current policy objectives is that the calculations suggest that a low-level carbon charge would not suffice to bring net emissions in the year 2000 down to 1990 levels. In a recent publication<sup>9</sup> the Tasman Institute has summarised its own view of such modelling work as follows:

But the real sting is that we do not know what the substitution possibilities actually are. So we do not know what level of carbon tax is really required to achieve a particular target. We do know that playing around with taxation levels to achieve the appropriate effect would be enormously costly. We can, however, be confident that a low carbon tax would have little effect. So little that it can only be viewed as a gesture. A potentially expensive gesture, that puts a question mark over New Zealand's reputation (since the mid-1980s) for getting it right in tough policy areas such as tax, labour markets, SOEs and (it was thought) environment, despite the good sense of the approach of concentrating on carbon absorption (*op. cit.*, page 4).

## 5 COMMENTS ON METHODOLOGY

### 5.1 Price Equalisation and the Least-cost Approach

- 5.1.1 A central proposition in the discussion document is that a broad-based carbon charge offers the least-cost means of achieving a quantity target for net emissions.<sup>10</sup> The discussion document comes to this conclusion in section 7.2 regardless of whether New Zealand acts alone or in concert with other nations and regardless of whether the government's policy objective is directed at reducing net emissions from New Zealand alone or global net emissions (see section 3.1 above).
- 5.1.2 While the NZBR is a longstanding supporter of broad-based, low rate taxes, it does not follow that the proposition in 5.1.1 above can be assumed to apply to every set of circumstances. For example, in the debate about how to best interface New Zealand's tax arrangements with the international tax regime, much of the Treasury's analytical work is devoted to considering the case for differential tax rates depending on the investor's country of residence or the country of origin of the investment income.

<sup>9</sup> Tasman Institute Occasional Paper B32, February 1996, *Tax or Credit? – NZ Policy on Carbon Dioxide Emissions*.

<sup>10</sup> See, for example, section 6.2.

- 5.1.3 The discussion in section 7.2 of the discussion document does not address the question of the optimal policy for New Zealand if effective rates of tax on carbon emissions vary widely across countries and if the New Zealand government does not wish to achieve its CO<sub>2</sub> targets by policies which see significant emitting activities migrate to low tax jurisdictions for minimal benefits in terms of reduced global emissions. The only point we wish to make here is that it is possible in this situation that it would be preferable to tax less heavily those domestic activities which would otherwise migrate to low tax countries.
- 5.1.4 We make no claim that such a non-uniform rate of impost is likely to be optimal. It is more likely to be optimal the greater the dispersion between New Zealand's effective tax on emissions and emissions in countries which would be logical candidates to process upstream materials exported from New Zealand. In addition, the non-uniform rate is more likely to be optimal the more accurately information about migration probabilities can be obtained at a centralised level. These are empirical issues which should be examined explicitly.
- 5.1.5 Perhaps the case for a uniform rate is strongest when it is set at such a low rate that it is expected to have no material impact. But such a policy would not be credible in terms of the government's stated objectives, as illustrated by the material at the end of section 4. If its ostensible purpose is to boost New Zealand's credibility in international forums, it should be evaluated in terms of the impact on that objective, compared to the costs and benefits of alternative approaches. On the other hand, it might cause industries to relocate anyway at the margin if the initial rate of charge is seen by firms as a Trojan horse so that the imposition of a low initial charge creates the expectation of much higher future charges.

## 5.2 Permits versus Taxes

- 5.2.1 The issue of the choice between permits and taxes requires much more investigation. Much depends on the detail since the two approaches are equivalent in the abstract. We restrict ourselves here to some observations on points made in the discussion document.
- 5.2.2 Section 6.8.6 discusses the issue of the allocation of certificates under a permit system. On page 96 the discussion document concludes that certificates should be allocated competitively in order to minimise overall economic costs. Some of the discussion document's efficiency arguments against alternative arrangements (such as grandparenting) are cogent. Others are equity arguments rather than efficiency arguments. One of these appears to be based on the unfounded proposition that something which is likely to increase government revenue must be positive in terms of consumer welfare. The unquestioned presumption is that deadweight losses can be ignored and future governments will use that revenue to add to national welfare.
- 5.2.3 This bias aside, our major concern is that the discussion document's case is incomplete in that it does not note a potentially important argument against tendering. This is that auctioning can impair dynamic efficiency by inhibiting future investment in sunk cost activities. Take, for example, the decision to invest in a pulp mill. Much of this investment is a sunk cost. If, after an investment is made, a government introduces permits which the incumbent operator must bid for in order to continue in business, the operator will be prepared to bid a price for that permit which transfers to the government all the sunk value of the investment. This appropriation of wealth, if seen to be opportunistic, would make

all future investors more cautious about investing in sunk cost assets in New Zealand.

- 5.2.4 For this reason it may be more difficult, in practice, for a government to avoid grandparenting arrangements than the discussion document envisages.
- 5.2.5 Nor does a carbon charge approach necessarily avoid this problem (refer to the discussion in the discussion document on page 91). A carbon charge set at a level equivalent to the price at which permits would have been allocated by auction is likely to have just as large and harmful an effect in expropriating from investors the value of sunk cost investments.
- 5.2.6 The vigorous debate in the fishing industry over the allocation of permits for new species and the setting of a resource rental tax illustrates the practical importance of this sunk cost issue. The discussion document notes the difficulties experienced in fishing on page 99 but simply assumes that no efficiency issues were at stake.

### 5.3 Road Pricing Issues

- 5.3.1 Commenting on the Land Transport Pricing Study was outside the working group's terms of reference. However, on page 76 the discussion document does anticipate that this study might lead to recommendations which would significantly reduce emissions from road transport.
- 5.3.2 We see three reasons why policy makers should hesitate to make this presumption. First, the discussion document inconsistently presumes that road prices should be based on recovery of historic costs rather than future costs, while making exactly the opposite presumption in respect of rail. In fact, revenue from road users is more than recovering current outgoings including capital expenditures.
- 5.3.3 Second, much revenue from road users is currently being derived from the petrol excise tax. This will be reducing fuel usage relative to levels which would be optimal on the basis of the opportunity cost of fuel to the nation. When direct billing technologies are introduced, motorists will not be slow to point to the (efficiency) case for reducing or eliminating fuel excise. The net effect could be increased fuel consumption.
- 5.3.4 Third, most of the road network is underutilised all of the time. The case for raising use-related charges on all users of all parts of the network because a small part of the system is congested at rush hours has yet to be made, and would be unlikely to withstand scrutiny.

### 5.4 Economic Costs

- 5.4.1 Figure 7.3 on page 110 of the discussion document purports to show the economic costs of reducing CO<sub>2</sub> emissions. Instead it shows the deadweight losses which arise when some factor prevents socially profitable transactions (that is, those in which the marginal social benefit exceeds the marginal social cost) from occurring.
- 5.4.2 The discussion document's interpretation of figure 7.3 is surely controversial. If a carbon charge were correcting an environmental externality, the figure would actually show the (partial equilibrium) *benefit* from a carbon charge in the form of

reduced deadweight losses. The same type of diagram might also be used to illustrate the possible additional benefit from using the proceeds of any such corrective tax to reduce distorting taxes.

- 5.4.3 Any economic costs arising from the imposition of a corrective tax would not be shown in the figure. They would arise from the costs of reallocating resources in the economy in response to the corrective tax, the costs of complying with, administering and enforcing the tax, and the costs of any wasteful government expenditures which result from the increased government revenues.
- 5.4.4 Contrary to its title, therefore, the figure mis-labels a benefit from a corrective carbon charge as a loss and fails to identify any of the economic losses which are relevant to a cost-benefit comparison.
- 5.4.5 On the other hand, the carbon charge would be unproductive if it had no social benefits (for example, because it had no effect on global climate change or because individuals derived no benefit from any effects on global climate change). In this case the charge would prevent welfare-enhancing transactions and the figure could be used to demonstrate the static deadweight losses of such a situation. However, the figure would not show the other likely costs mentioned above. Nor would it show the likely adverse effects on future investment decisions of uncertainty about the future levels of such a charge.
- 5.4.6 The potential importance of dynamic costs was raised in figure 7.4.1 in the discussion document. This figure makes the point that if expectations are ignored, a policy of stabilising net emissions in a growing economy would require that the carbon charge increase with time in order to choke off the tendency for emissions to increase with output. Obviously expectations that a carbon charge will increase through time provide an incentive to deplete fossil fuels sooner rather than later and should be taken into account.
- 5.4.7 In the light of these concerns, it is hard to avoid the conclusion that the discussion document does not adequately meet the requirement in the working group's terms of reference that it provide:

... a rigorous analysis of the costs and benefits of each option (including environmental risks, costs and benefits).

## 6 CONCLUDING COMMENT

- 6.1 Our fundamental concerns with the contribution of the discussion document to the minister's laudable goal of a well thought-out policy position which is understood domestically relate to matters outside the control of the working group. These are the unclear relationship between the government's targets for the year 2000 and welfare maximisation; the rationale for the government's position on a unilateral carbon charge in 1997; and the fact that the target for the year 2000 is unlikely to be achievable under current projections with only a low-level carbon charge.
- 6.2 The analysis in the discussion document appears to support the inference that no convincing case has been made that projected global warming to the year 2100 would produce negative net benefits for New Zealand residents, that preventive measures have net benefits relative to adaptation, and that other Annex I



countries are taking effective measures for the explicit purpose of materially reducing net emissions.

- 6.3 In our view, the government faces considerable difficulties in persuading the community that it is desirable to incur real economic costs in the quixotic pursuit of its target for the year 2000. In particular, the imposition of a low-level carbon charge – whether through a tax, a permit system or a hybrid – lacks credibility as a response to the perceived problem in our view.
- 6.4 In the absence of any solid case that projected global warming would have an adverse effect on New Zealand citizens, the government's real problem may be to determine how to be seen to be 'playing its part' in international forums at least cost in terms of domestic welfare. If so, the problem should be explicitly analysed in these terms. Other countries such as Australia and the United States are not contemplating unilateral action in the form of a carbon charge. It is surely not necessary, therefore, for New Zealand to take a different path. Where, then, is the political economic analysis which shows that it is desirable for New Zealand to do so?

**THE LABOUR MARKET AND  
EDUCATION**

**INSTITUTE FOR INTERNATIONAL RESEARCH  
11TH ANNUAL INDUSTRIAL RELATIONS CONFERENCE**

**OBSTACLES TO EMPLOYMENT AND  
PRODUCTIVITY GROWTH IN  
NEW ZEALAND'S LABOUR MARKET**

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

**AUCKLAND  
3 MARCH 1997**

## OBSTACLES TO EMPLOYMENT AND PRODUCTIVITY GROWTH IN NEW ZEALAND'S LABOUR MARKET

There seems to be a natural life cycle to most soundly based economic reforms:

- first a period of denial of the need for change and fierce opposition to reform proposals;
- secondly, the build-up of a political consensus that the old ways were not working and the implementation of a policy change;
- thirdly, a growing public acceptance of the reform as the benefits show up, to the point where it loses its controversial edge and fades from the political agenda.

This cycle has run its course with the abolition of import licensing, financial market deregulation, goods and services tax, liberalisation of shop trading hours, port reform, the Reserve Bank of New Zealand Act 1989, corporatisation and the great majority of New Zealand's other recent economic reforms.

We seem to be in the third of these phases with the Employment Contracts Act 1991 (ECA). Two general elections after its implementation, one of them under new electoral rules, the ECA seems to be securely in place. Five years ago opponents of the ECA outnumbered supporters by nearly two to one; in recent polls more people have approved of it than disapproved. At the last general election, 60 percent of the electorate voted for parties which supported the ECA. This was reflected in the coalition agreement to retain the legislation and indeed to address some of its weaknesses. In its negotiations with New Zealand First, Labour backed off its policy of repealing the ECA, and it will no longer be credible for Labour to revert to that stance. Moreover, unlike the situation under first-past-the-post, there seems little prospect under the mixed member proportional system of any coalition of parties committed to repeal of the ECA being able to form a government.

Developments and debate internationally have confirmed the correctness of New Zealand's decision to opt for a flexible, decentralised labour market. The Howard government in Australia has abandoned the centralised Accord and it seems unlikely to be revived. Britain, the only Organisation for Economic Cooperation and Development country besides New Zealand to implement major labour market reform in recent years, now has an unemployment rate of 6.5 percent, whereas unemployment in much of continental Europe is around twice that level. The flexible US labour market has created a net 8 million jobs since 1991, whereas the European Union has lost 5 million. And the fast-growing Asian economies with the freest labour markets of all are continuing to maintain high growth and low unemployment.

We can now survey the record of nearly six years' experience since the ECA was enacted in May 1991 and compare it with the predictions of collapsing wages, anarchy and exploitation made by some at the time. Since the recession ended in mid-1991:

- output has grown by nearly 20 percent, and the economy is into its sixth successive year of economic growth;
- employment has grown by over 220,000 jobs (at an average annual growth rate of 4.5 percent in the last three years), and there have been more jobs created than there were unemployed in 1991;
- the number of people working full-time has increased by 159,000, some 72 percent of the new jobs;

- the unemployment rate has fallen from its peak of 10.9 percent (seasonally adjusted) in the September quarter of 1991 to 5.9 percent in the December quarter of 1996;
- long-term unemployment has fallen faster than the overall unemployment rate and has dropped by over 40 percent in the last two years;
- the rate of employment growth has been higher for Maori and Pacific Islands people than for Europeans, and unemployment has declined for all ethnic groups and across the country.

Of course, not all of these improvements can be attributed to the ECA. Separating out the effects of the ECA from other influences is a difficult, if not impossible, task. The best attempt has been made by Tim Maloney of the University of Auckland. His latest work suggests that around 16 percent of the growth in employment – itself a large number – may be directly due to the ECA, and an indeterminate amount (at the limit 100 percent) may be due to its direct and indirect effects combined. However, Maloney's results are driven largely by the postulated employment creation effects of the fall in unionisation in different industries. While this effect is plausible (since we have long known that unions and collective bargaining in regulated labour markets are bad for employment), it captures only part of the job creation story.

In my view, the problem of estimating the employment effects of the ECA in a precise way with any analytical model is virtually intractable. One can get a better feel for them by looking at the comparative experiences of New Zealand and Australia in recent years. While economic growth in New Zealand and Australia has been similar since mid-1991, employment growth was 15.1 percent in New Zealand, compared with around 8 percent in Australia. Unemployment has fallen in New Zealand to 5.9 percent of the labour force, but it has fallen from a similar peak in Australia to only around 8.5 percent. Moreover, virtually all Australian observers expect unemployment in Australia to remain stuck at about that level over the next few years because the Howard government has done too little to create a genuinely free labour market, whereas in New Zealand unemployment should continue falling.

Thus there is little doubt that the ECA has been a phenomenal job creation machine, whereas the previous regime was a machine for job destruction. Under the Labour government's unbalanced economic framework, employment actually fell (by 17,000 jobs) in New Zealand between 1984 and 1990. The ECA has also brought about enormous changes in enterprise culture, in particular, far greater trust and cooperation in workplaces, less disputation and more job security. However, some critics have still not given up: the patently silly claims about the 'Richardson recession' and then 'jobless growth' have given way to debates about productivity and income trends. I am confident that events will show that the critics' views on these issues are equally mistaken.

On productivity, the argument is that productivity growth has been poor since 1991. A forthcoming New Zealand Business Roundtable study by Geoff Hogbin will explore this claim in detail. No one should expect growth in average labour productivity to be sensational at a time when the economy has been absorbing thousands of unemployed workers, many of them with low skills. This point notwithstanding, microeconomic data, such as firm-based surveys, point to significant productivity gains: the New Zealand Institute of Economic Research found that 75 percent of firms considered the net impact of the ECA on productivity had been positive. Moreover, the best general study to date, by Professor Viv Hall of Victoria University, shows no story of a slowdown even in average labour productivity. Far from being 'poor', labour productivity growth has held up at an average of 2.0 percent a year. More importantly, the post-ECA economic expansion shows much greater capital productivity growth (2.7 percent versus 0.0 percent) and considerably higher total

factor productivity growth (2.3 percent versus 1.3 percent) compared to the previous expansion phases. With the labour market tightening, future growth in output will depend increasingly on productivity growth driven by investment in physical and human capital, continuing structural and technological change, and a sound structure of incentives in all markets.

In respect of income trends, the Treasury pointed out in its post-election briefing that some degree of wage disparity between high- and low-skilled jobs is needed to generate the dynamic processes required to make human capital a more significant driver of productivity growth, and over time to reduce poverty and income disparities. The post-ECA period has seen greater rewards for skill, and the number of industry trainees is at an all-time high. The ECA has also brought about a radically changed relationship between labour market insiders and outsiders, with the unemployed having greater opportunities to compete for jobs. The available data suggest that measures of poverty and inequality both increased with rising unemployment in the late 1980s and early 1990s, due to the Labour government's failure to tackle the problem of the rigid labour market. From 1992/93, the trends appear to have reversed, consistent with the view that economic and employment growth are the key drivers of reducing hardship.

Recent research also reported by the Treasury highlights the significant employment effects of the welfare system reforms of 1991. This research shows that the widening of the gap between income from employment and income from welfare benefits increased labour force participation by two percentage points; increased total employment by 2.5 percentage points; reduced the unemployment rate (as defined in the Household Labour Force Survey) by 0.7 of a percentage point; and induced more young adults to participate in education and training.

Thus while some people were obviously worse off immediately after the benefit cuts, the longer-term results have clearly been positive for many. For most people the best way out of poverty is to get a job, even at a low entry level wage. Just over a quarter of people in the lowest 20 percent of the wage and salary distribution move to a higher income group within a year. Moreover, the data suggest that people on low wages and salaries tend to receive on average larger proportionate increases in remuneration than those higher up the earnings distribution.

Thus New Zealand's experience provides strong confirmation of the view that modern unemployment is largely attributable to regulations which impede the functioning of labour markets and poorly structured welfare systems. Europe, with both highly regulated labour markets and big welfare states, has endemic structural unemployment. The high-income Asian countries have maintained open and competitive labour markets and avoided large-scale state welfare, and have consequently enjoyed low unemployment, rapid economic growth and a relatively even distribution of income. Naturally, general economic growth also assists job creation, and is in turn fostered by sound labour market and welfare policies.

It has been a matter of great frustration that most New Zealand commentators have missed the importance of these policy reforms in alleviating New Zealand's unemployment problem. For 10 years the Business Roundtable has been arguing that unemployment in New Zealand is an economic and social scourge (there are still some lame brains who think employers benefit from 'a pool of unemployed'); that the levels reached in the 1980s were a disgrace; and that restoring full employment is a wholly feasible objective. For much of that time our arguments fell on deaf ears. Even Bill Birch, one of the architects of the ECA, could not see the unemployment rate falling below 7-8 percent. The Department of Labour has been consistently far too pessimistic with its unemployment forecasts, and the latest drop in the unemployment rate to 5.9 percent again came as a surprise to most commentators. Lately we have been arguing that full employment - which probably means a measured unemployment rate of perhaps 1-2 percent, because people are always joining or

leaving the labour force or changing jobs – should be achievable by the year 2000. I suspect most people still do not take that proposition seriously. Journalists seldom bother to report our efforts to promote such goals; they like to concentrate on issues that excite reaction. Yet, as the head of the Treasury in Australia has put it, unemployment is not inevitable – it is largely a matter of choice.

New Zealand will continue to make further inroads into unemployment only if it maintains sound economic, labour market and welfare policies, and improves them where possible. It will not do so if it gets diverted into palliatives such as so-called job-creation or work-for-the-dole schemes. Most of the existing Department of Labour schemes do nothing to increase total employment and, given today's much more favourable labour market, they should be scrapped. This is not to knock the thinking behind work-for-the-dole proposals: people should be strongly encouraged to move from welfare into work, and those receiving assistance from other taxpayers have a reciprocal obligation to become self-supporting wherever possible, whether they are on the dole or other benefits. It is simply that such thinking should be refocused back towards more fundamental labour market and welfare policy issues.

This conference is about industrial relations, so I shall elaborate only on policy issues in this area. The most important of these is the problem of the Employment Court or, more precisely, the tangle created by the combination of the decisions taken in 1991 to enact statutory personal grievance procedures and to retain a specialist labour court.

These provisions of the ECA were a great mistake, as many of us argued at the time. The court has come to be known as the Unemployment Court, because it has manifestly kept New Zealand's rate of unemployment higher than it would otherwise have been. I would estimate conservatively that unemployment would be below 5 percent by now were it not for these deficiencies in the ECA and the attitude of the courts to its administration.

A study by Charles Baird published by the Business Roundtable and the Employers Federation last year documented some of the consequences of the Court's rulings in the area of dismissals.<sup>1</sup> It concluded that, on the basis of US experience, the results could include:

- a loss of between 19,000 and 47,000 jobs;
- a 7 percent reduction in real wages paid to workers; and
- an 18 percent decrease in the mean income received by households in the lowest income quintile.

Whatever the precise magnitudes, there is no question that unjustifiable dismissal laws are a tax on employment and that they mostly hurt workers and the unemployed – not owners of capital who, at least in the long run, can redirect their capital elsewhere, including overseas.

The economic and legal issues that arise in this area have been elaborated in many Business Roundtable studies, and I will not rehearse them here. The essence of the story is that mandatory rules on job termination are a departure from the freedom of contract philosophy that lies behind the ECA and detract from its objective of creating an efficient labour market. Once upon a time legislators and the courts had it right in this area. As an oft-quoted decision by an American Supreme Court put it:

<sup>1</sup> Baird, Charles W. (1996), *The Employment Contracts Act & Unjustifiable Dismissal: The Economics of an Unjust Employment Tax*, New Zealand Business Roundtable and New Zealand Employers Federation, Wellington.

Men must be left without interference to buy and sell where they please and to discharge or retain employees at will for good cause or for no cause, or even for bad cause, without thereby being guilty of an unlawful act per se. It is a right which an employee may exercise in the same way, to the same extent, for the same cause or want of cause, as the employer.

Since that time the right of workers to quit at will (subject to any terms of a contract) has not been put in question – even though some decisions to quit clearly inconvenience or harm employers. Prior to the 1970s the same rules applied to employers, and until the ECA was introduced they did not apply to the large proportion of the workforce who were on individual contracts and were not union members. The ECA was a massive step backward in this regard, and Employment Court rulings have made the problem worse. The extension of the law to employees in the executive category, for example, is probably the greatest protection system for incompetent managers ever devised. Inevitably, consumers end up paying the costs.

Behind these developments is the same ideology that was rightly set aside in reforming most other features of New Zealand's labour law, namely that helpless employees must be protected from omnipotent employers. We all deal satisfactorily with banks, retailers and other firms with far greater resources than we have, without the aid of laws on minimum deposit rates and maximum retail prices, and without resorting to unions of savers or consumers. This alone suggests that there must be a strong measure of myth in the doctrine of unequal bargaining power. If bargaining power was a systematically one-sided problem – as opposed to something which fluctuates with market conditions and which affects employers and employees alike – we would expect to see wages driven down towards zero in countries without minimum wages, employees without the power to quit at will, and the prices of goods sold by big firms tending towards infinity.

Of course, none of this happens, because it is not the difference in resources between buyer and seller that matters, but the alternatives available to each. Employers and workers are not in competition with each other: employers are in competition with other employers for workers and employees are in competition with other employees for jobs. In all markets, including the labour market, the best protections for savers, consumers and workers are freedom of entry and exit on both sides of the market, and openness to competition. Hong Kong has no minimum wage or unfair dismissal laws. Because these freedoms have helped it to maintain virtually full employment despite massive structural change, its workers are not easily exploited and they now enjoy average incomes 50 percent higher than those of New Zealand workers.

This is not to say that employers and employees have no inclination to behave opportunistically. Rather, the circumstances in which opportunistic behaviour is profitable are relatively rare. One reason is that it is normally profitable to strive to achieve and maintain a reputation as a good employer. Another is that contractual arrangements have evolved through market processes to safeguard against opportunistic behaviour on the part of both parties to an employment contract.

The legal scholar Richard Epstein has repeatedly emphasised the folly of judicial intrusion into routine affairs such as employment contracts:

It is one thing to set aside the occasional transaction that reflects only the momentary aberrations of particular parties who are overwhelmed by major personal and social dislocations. It is quite another to announce that a rule to which vast numbers of individuals adhere is so fundamentally corrupt that it does not deserve the minimum respect of the law. With employment contracts we are not dealing with the widow who sold her inheritance for a song to a man with a thin moustache. Instead we are dealing with the routine stuff of ordinary life; people who are competent enough to marry, vote, and pray are not unable to protect themselves in their day-to-day business transactions.



Beyond the issues that arise in standard contract law – such as fraud, misrepresentation and duress – employment contracts do not leave gaps or implied terms that courts need to fill. Employment contracts are made every day; the costs of contracting are low; and people can evaluate realistically the risks and costs of contingencies such as dismissal. If it is optimal for workers to have job security or just dismissal provision they will negotiate one voluntarily because the barriers to doing so are trivial. If not, they will choose to avoid the costs to them of lower wages or other less favourable terms in their contract which are the inevitable trade-off for greater job security. In short, mandatory unjustifiable dismissal provisions diminish the value of the compensation bundle for most employees.

Thus the problem that activist legislators or courts seek to address is an imaginary one, and their decisions harm the very parties they hope to benefit as a class. Activist judges often find meddling in other people's affairs a rather pleasant burden, but this tendency lends itself to abuses of power. The law has no economic rationale for a good faith or fair dealing intervention in labour relations. Economic competition does not create a perfect world, but on both the demand and supply sides of the market it provides incentives for civil and cooperative behaviour. Firms do not sack workers willy nilly; such practices are virtually unheard of as they are bad business and the costs of changing staff can be high. New Zealand employers have every incentive to keep and reward quality employees – after all, there are over 200,000 firms that can bid them away at any moment. The at-will contract is often the best mechanism for establishing terms of employment which avoid vulnerabilities, opportunism, one-sidedness and monopoly by either party in an employment relationship. If, subject to the terms of a contract, an employee can quit at any time, the firm has every reason to be responsive to the employee's concerns. If, subject to the terms of a contract, an employee can be dismissed at any time and for any reason, that employee has every reason to be productive. Productivity creates job security.

There are signs in the coalition agreement negotiated by National and New Zealand First that some of these realities have finally been recognised. The document refers to "judicial activism", and hints at the possible termination of the separate jurisdiction of the Employment Court. The briefing provided to the coalition parties by officials during the negotiations highlighted the problems of legalistic 'good faith' and 'fair' bargaining doctrines.

In its briefing to the incoming government, the Department of Labour raised the question of whether the problems experienced with decisions by the Employment Court and Court of Appeal were best addressed by legislative amendment or changes to institutional structures. The answer is that both are needed.

The National government drew back from abolishing the separate jurisdiction at the time the ECA was passed because some of its members regarded that move as a bridge too far at that stage. They took the view that after it became clear through experience that employment contracts were no different from other contracts, the task could more easily be handed over to the general courts. That step should now be taken. In addition, now that the government has sensibly dropped the idea of abolishing appeals to the Privy Council, access to that court for employment cases should also be reinstated on the grounds that this area of the law should be treated no differently from other commercial contracts.

If the courts could be trusted to administer employment contracts on the same basis as other contracts, there would probably be no need for an employment statute at all. Until that point is reached, parliament needs to make its intentions clear, and the most important change needed to the ECA is to put beyond doubt the ability to freely negotiate at-will contracts, including contracts requiring a simple period of notice before termination. At most, parties should have as a default option the right by negotiation to adopt statutory dismissal provisions or, less desirably, to opt out of

them. Various other provisions of the ECA should also be simplified or discarded. As a minor example, no purpose other than bureaucratic and academic employment is now served by putting firms to the cost of reporting the details of thousands of employment contracts to the Department of Labour, and this requirement should be dropped.

Obstacles to job creation in other employment legislation should also be addressed if New Zealand wants to take seriously the objective of restoring full employment. An example is the current statutory minimum wage, which is a prime illustration of confused thinking on how to help people at the bottom end of the labour market.

The coalition parties have decided to increase the adult minimum wage to \$7 an hour and may increase it to \$7.50 next year. This new obstacle to the rights of low-skilled people to sell their own labour is an extraordinary decision. At \$7.50, the minimum wage would be above the level of the minimum wage in the United States, yet average incomes in New Zealand are only around two thirds of US levels. There is little argument among economists in the United States that its minimum wage laws typically cost jobs: the only debate is over the numbers lost.

Clearly the relative impact of the coalition government's decision will be far greater. It went against the advice of all its departmental advisers in making this decision – even the Department of Labour has now come round to warning of the negative effects of minimum wage laws. These fall most heavily on the young, the unskilled and less productive workers – the very people who should face the fewest obstacles to getting a foothold on the bottom rung of the earnings ladder. Labour and the Alliance are even more strongly attached to a policy which panders to populist instincts and the interests of their supporters in the union movement, but which offends any rational concept of equity.

Other employment legislation hinders job creation. The government plans to review the Holidays Act 1981, where basically the principle of voluntary choice and freedom to contract should be allowed to prevail. The Human Rights Act 1993 discourages employment by raising the costs of hiring through restrictions on advertising and recruitment. Privacy and occupational health and safety laws have also increased employment costs and risks for firms. The gross inefficiencies of the Accident Rehabilitation and Compensation Insurance Corporation, which accounts for the largest element in non-wage labour costs, are another major employment tax which affects jobs and wages. It is distressing that the Labour party still keeps coming up with ideas like maternity leave legislation which would increase non-wage labour costs and hurt the employment prospects of the very people its members tell us they care about, in this case women in the child-rearing age group. There is an equally long agenda in the welfare area which would include such things as time limits or two-tiered levels for unemployment and other benefits, and greater obligations on beneficiaries to seek and accept work.

However, there is a lot more that could be done to improve the operation of New Zealand's labour market, our employment prospects and economic growth. There is clear evidence that labour markets work if they are not constrained from doing so. Because unemployment is largely a matter of policy choice, those who resist the removal of these constraints either do not understand how labour markets work or they must argue that unemployment should be accepted because the costs of eliminating it are too high. That is a hard argument to make.

In a recent lecture on why some nations are rich and some poor, the distinguished economist and public choice theorist Mancur Olsen said: "The best thing a society can do to increase its prosperity is to wise up." He was making the point that economic performance is mostly determined not by a country's natural endowments, the availability of technology or capital accumulation, but by the institutional arrangements it adopts and the structure of incentives they generate. Olsen added

that those who prevail in the fight against special interests and quacks make an extraordinary contribution to the amelioration of poverty and the progress of humanity. When it comes to labour markets, and the entirely feasible goal of becoming a high employment, high productivity and high income economy, will New Zealand have the wit to "wise up"?

**MINISTRY OF EDUCATION  
LEARNING AND EVALUATION POLICY UNIT**

**A CURRICULUM FOR THE SOUL  
SOME THOUGHTS ABOUT THE CURRICULUM  
AND THE PURPOSES OF SCHOOLING**

**MICHAEL IRWIN  
POLICY ANALYST  
NEW ZEALAND BUSINESS ROUNDTABLE**

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## A CURRICULUM FOR THE SOUL: SOME THOUGHTS ABOUT THE CURRICULUM AND THE PURPOSES OF SCHOOLING

You have asked me to talk about curriculum issues and, in particular, to address some of the philosophical issues that should underpin your work. The invitation said that you are re-examining issues such as the purposes of education and what effective education might mean. I welcome the invitation and more especially the time you are taking out to think about deeper aspects of your task without the distractions of immediate crises. I read into your invitation a certain licence to stimulate, even to provoke, and I trust I did not infer more than was intended.

The ministry of education in New Zealand has begun the task of reorganising the national curriculum for New Zealand schools. The aim has, in part, been to rein in disparate parts of the previous curriculum within a more coherent framework and to be more precise about what children should be taught at various stages of their education.

I don't propose to review the particular processes that were adopted – the levels, the essential learning areas, the essential skills, the structure of aims and outcomes, and so on. I have addressed these in other papers and on other occasions (Irwin 1994a and b, and 1996a and b). The individual curriculum statements have been the subjects of submissions or critiques by the Education Forum which are on the record.

I very much hope that your present exercise is the beginning of a rethink about those structures and materials. If so, you are starting at the right place – the assumptions underlying education and the issue of what an effective education system might look like. Of course, such questions raise many issues, but I will confine myself to the assumptions related to the curriculum.

You will need to be on your guard against simplistic approaches that skate over more fundamental issues as if they were not problematical. So often we hear statements that clearly imply that all that is required is increased budgets, improved equipment, and access to the latest technological resources and, hey presto, educational standards would rise in immediate and direct response. Unreconstructed politicians, bureaucrats, teacher union officials and media commentators say this all the time. They infer that the basic aims of education and the means by which they should be achieved are all clear, and it is only sophists and professional agitators in places like the New Zealand Business Roundtable who think otherwise.

We have, of course, a national curriculum and most of the key curriculum statements are in place. Certainly there are unresolved issues, and ironically the ministry appears to need assistance in establishing what the rationale for Social Studies might be (*Education Review*, 23 January 1997). My question would be rather different and more fundamental: whether there is a rationale for Social Studies as a separate subject at all. While you do not start with a *tabula rasa*, we can look at the new curriculum documents to raise questions and observations about the fundamental philosophical questions with which you are presently engaged. But you should never, as policy analysts, accept the *status quo*, however recent, as set in stone for all time. If, as I would aver, much of the recent curriculum work has been of second-rate quality, you must be ready for those windows of opportunity to make changes for the better. But you must know what the first-rate configuration might look like if the changes you advocate are going to take you nearer it rather than further away.

It is as well at this stage to make an obvious but important observation. The school system is extensive – some 2700 schools and 40–50,000 teachers. Basing the

curriculum on the soundest assumptions is only the start. David Hargreaves wrote recently what many others have said before:

Schools, and especially classrooms, are remarkably resistant to change, much to the consternation of politicians, policy makers and innovators. Indeed, the main barrier to change may be the professional culture of teachers and the nature of school and classroom organisation. Professional and institutional structures and cultures are resilient; they withstand many an assault and have powerful capacities to maintain and reproduce themselves despite surface changes. (Hargreaves 1994)

Certainly, the New Zealand education system does not suffer from an auto-immune deficiency syndrome. It resists all assaults, perhaps especially those which have to do with pedagogy and epistemology. The resistance to critiques of the 'whole word' teaching of reading, child-centred pedagogy, or of forms of constructivism have often taken the form of personal attack on those making the criticisms. The ministry, in my view, is too often unwilling to engage in serious conversation on such matters. Too often it seems to say in effect that 'this is the way it is, this is the way it is going to remain, and if we haven't analysed everything in writing to the degree some pedants think necessary the sector can nonetheless be confident that all relevant research findings are in our heads, and that we know the answers. Moreover, we are not interested in contrary views'.

Christopher Woodhead, the Chief Inspector of Schools in England, put a very different view recently. He said "The debate in education should be characterised by a sense of intellectual adventure: by an enthusiasm for a critical reflection on ideas, values, assumptions, current practices, by a refusal ever to allow a working hypothesis to harden into unexamined orthodoxy." (Woodhead 1995)

How should we go about investigating our 'working hypotheses' and examine whether they have hardened into unquestioned orthodoxy? I suspect the answer – or an important part of it – is to maintain foremost in one's mind a sound view of the nature of the educational enterprise, and for this I will take as my text Michael Oakeshott's essay *Education: The Engagement and its Frustration*. Oakeshott said education is:

... the transactions between the generations in which newcomers to the scene are initiated into the world which they are to inhabit. This is a world of understandings, imaginings, meanings, moral and religious beliefs, relationships, practices – states of mind in which the human condition is to be discerned as recognitions of and responses to the ordeal of consciousness. These states of mind can be entered into only by being themselves understood, and they can be understood only by learning to do so. To be initiated into this world is learning to become human; and to move within it freely is being human, which is an 'historic', not a 'natural', condition.

The education enterprise is, for Oakeshott, central to the human condition. Thus no enterprise is more important, for to be without these understandings is "to be not a human being, but a stranger to the human condition." But I would stress his observation that to be educated is not a natural condition. His starting point is, in fact, that education "is a difficult engagement of learning by study in a continuous and exacting redirection of attention and refinement of understanding which calls for humility, patience and courage."

In case this sounds hopelessly Victorian or perhaps just conservative, let me quote Gramsci, a leading member of the Left in Europe between the two world wars. He wrote:

In education one is dealing with children in whom one has to inculcate certain habits of diligence, precision, poise (even physical poise), ability to concentrate upon specific subjects, which cannot be acquired without the mechanical repetition of disciplined and methodical acts ... . It is also true that it will always be an effort to learn physical self-discipline and self-control; the pupil has in effect to undergo a psycho-physical training. Many people have to be persuaded that studying too is a job, and a very tiring one, with its own particular apprenticeship – involving muscles and nerves as well as intellect. It is a process of adaptation, a habit acquired with effort, tedium and even suffering. If one wishes to produce scholars, one has to start at this point and apply pressure throughout the educational system in order to succeed in creating those thousands or hundreds or even dozens of scholars of the highest quality who are necessary to every great civilisation. (Gramsci 1971)

It seems to me that both the 'conservative' Oakeshott and the Marxist Gramsci were saying much the same thing. And what they were saying is very far from the emphases we find in the principles of the New Zealand Curriculum Framework, which are more on what schools must do for students – the enabling, empowering and respecting of students – and not what is required of students themselves, such as the effort to be exerted, the tedium and difficulties to be faced, and the self-discipline required.

Oakeshott was also interested in what he called the 'intellectual virtues' and asked questions such as these:

How does a pupil learn disinterested curiosity, patience, honesty, exactness, industry, concentration and doubt? How does he acquire a sensibility to small differences and the ability to recognise intellectual elegance? How does he come to inherit the disposition to submit to refutation? How does he not learn merely the love of truth and justice, but learn it in such a way as to escape the reproach of fanaticism?

Oakeshott is a deeply unfashionable philosopher in contemporary educational circles, and it comes as no surprise that we find few references to these intellectual virtues in the curriculum documents. We find instead repeated emphases on the school curriculum as a means of creating a certain sort of person to take his or her place in a certain, preconceived sort of society which is part of a "competitive world economy" (Ministry of Education 1993). This is an approach to education which Oakeshott would call 'socialisation', by which he means "systematic apprenticeship to domestic, industrial and commercial life".

I do not, for a moment, mean to imply that education has no part to play in preparing young people for the world of work. Indeed I am on record for saying that one of the great disappointments with the National Qualifications Framework is that it promises not only to trivialise much of 'academic' or 'general' education but also is unlikely to provide quality vocational qualifications for those who, for reasons of ability or aspiration, intend to go into the workforce on leaving school.

But this workplace orientation is not, I suggest, at the heart of the educational enterprise. Indeed for Oakeshott the substitution of 'socialisation' for education is a disaster of enormous proportions. Education is the disinterested study of what Matthew Arnold referred to as "the best that has been done and thought". It has no extrinsic purpose. 'Socialisation', on the other hand, can, as Woodhead has pointed out, only be justified in terms of goals external to itself which it is meant to achieve – social engineering, human resource management, and the like. Oakeshott saw this substitution as "the most momentous occurrence of [the 20th] century, the greatest of

the adversities to have overtaken our culture, the beginning of the dark age devoted to barbaric affluence."

If we do not recognise the deeper, intrinsic purpose of education we will be swept this way and that by educational and other fashions. Indeed in education we seem to grasp fashions from overseas more quickly, usually when they are beginning to wane elsewhere, to hold on to them longer, and to apply them with less care and more injury to the public good than other sectors of the community. Our commitment to the 'whole word' method of teaching reading to the substantial exclusion of phonics is an obvious case in point, but let me give you some other examples.

The concept of 'accountability' has been given strong emphasis in recent government reforms in New Zealand. In my view this has been all to the good in most cases. Yet in education we have taken this proper and much needed concept to ridiculous lengths in both our curriculum and qualifications frameworks. The curriculum framework document says that the national curriculum statements will specify clear learning outcomes against which students' achievement can be assessed. The design of the unit standards of the qualifications framework requires, in the oft-stated words of a former minister of education, 'clear and transparent standards'. Obviously, in the interest of exercising accountability, we would like to know *ex ante* what is to be taught and *ex post* what the student has actually learnt. But the way the concept has been developed has ignored the lessons from the study of behaviourism, the understandings of epistemology and the very finite limits of assessment technology. Certainly in the National Qualifications Framework we are facing an enormously costly monster and, in my view, much potential damage to the education of many young people.

In our curricular documents we refer to New Zealand's bicultural identity and multicultural society – themes which pervade the drafts of the Social Studies curriculum. But what on earth can a bicultural identity and the related and popular notion of partnership mean in modern New Zealand? It would seem to imply a society in which there are two cultures of approximately equal significance. Yet this is manifestly not so, and cannot be so. It is not a question of demographic statistics, of the unequal distribution of Maori and non-Maori in the population. One obvious fact is that all significant civic, legislative, constitutional and legal institutions of New Zealand are Western – or to be more precise of British origins, which themselves draw on even older thought and traditions including Greek, Roman, Hebrew and European philosophy over the last two thousand years or so. The language of everyday commerce is English using the Roman script and Arabic numerals. (I would note in passing that medieval Arab scholarship is also very much part of 'Western' culture). None of this is to denigrate the considerable achievements of Maori culture. But it is interesting to note that current arguments advanced by Maori for reparations for past injustice to Maori are couched in terms of current Western moral concepts – not those of traditional, pre-contact Maori culture.

The 'Westernisation' of New Zealand should come as no surprise. Western civilisation has a range of cultural possibilities which were simply not open to indigenous societies whether in New Zealand, the Americas or elsewhere (Minogue 1997). This is what makes Western culture so dangerous, or so it may seem to some. It can absorb other cultures, even take on some of their aspects, without itself being affected to any significant degree. It is the case for separate development – though not, of course, by the discredited name of 'apartheid' (Minogue 1997). It does no good to perpetuate through the school curriculum views about our national identity which do not withstand serious scrutiny, and which are likely to promote friction based on false hopes and a misreading of our society and its history.



We have a different form of this current bicultural concern to place equality above facts and history in what I might term 'bi-genderism'. The view here is that the curriculum must give equal weight to the contributions of women and men. We find this particularly in the English and Social Studies drafts. The problem in the former is that there was no equality in the literary contribution of men and women until relatively recent times and, as regards the latter, that the vast majority of events recorded in history related to the deeds of men and not women. Ignoring these facts – trying to establish some sort of *ex post* equality – is not education but indoctrination.

And multiculturalism – what does it mean? Well, certainly New Zealand is multicultural in that its population has diverse ethnic and cultural origins. But while we can accept multiculturalism as a fact, multiculturalism as an ideology is highly debatable. It does no service to confuse the two, as we do in various curriculum documents, by observing that New Zealand is multicultural and then proceeding as if the ideology is beyond debate.

Multiculturalism as ideology has become the moral mission of much of Western education (Orwin 1996) and has deeply influenced New Zealand education, often in a surreptitious, ill-informed way. The notion of multiculturalism depends on that of culture. More precisely, it depends on the relativistic understanding of 'culture' which currently dominates much of the English speaking world (Orwin 1996).

In its older sense, as in the expression 'a cultured person', the transmission of culture was the noblest task of the education system and especially the university. This traditional view of culture wasn't elitist – the cultural delights of the aristocracy were to be available to all. Arnold, to whom I have already referred, saw Western culture, deriving from Hellenic and Hebraic roots, as the very opposite of dogmatism and its only effective antidote. His view was that it "alone can lift us above our petty passions as individuals and those of party and time. Culture was good not only for the individual but for the polity: it defined the education suitable for free men" (Orwin 1996).

All this changed in the 1950s or thereabouts. Multiculturalism is now not just a statement of fact (the existence of ethnic and cultural diversity), it is an ideology and a political statement. It embraces not only the notion of cultural relativism but the civil rights movement, the various liberation movements that began in the United States, the post-modern celebration of difference and the anti-Americanism that became generalised into anti-Westernism (Orwin 1996).

If all cultures must be presumed equal then there is no reason why the education system should transmit one to the exclusion of others. It is ironic that this whole business of cultural relativism is essentially that of modern Western liberalism, and promoting multiculturalism is promoting a set of notions currently fashionable in Western, and especially English speaking, countries. And, of course, we do not in fact accept that all cultural practices are of equal worth and should be valued – the strictures of the New Zealand Curriculum Framework and the drafts of the Social Studies curriculum notwithstanding. But, as has been pointed out, the appeal of multiculturalism has never depended on its theoretical consistency; its appeal is political (Orwin 1996).

It may seem profoundly shocking to suggest that what is happening in New Zealand as regards ethnic relations and social relations more generally is an example of a widespread international fashion. The problem with fashions is, of course, that they come and, sooner or later, go. The danger of becoming locked into what will turn out to be a passing fashion is a real one, and the ministry should guard against such possibilities by actively promoting the enthusiasm for critical reflection to which I

have already referred. Indeed I understand that such promotion is precisely one of the aims of this planning session and a reason why I was invited to speak to you.

It will be asserted no doubt that in ethnic relations the Treaty of Waitangi makes the difference – that the New Zealand situation is unique. Well, of course, in a banal sense every country is unique, and there are some unusual characteristics about the nature of the Maori situation at first contact with the 'West'. But I would challenge New Zealand's essential uniqueness on a number of grounds. First, the issue of how minority ethnic groups should live within a country with a dominant culture is far from unique. It exists in many countries. Secondly, there are many examples of treaties between indigenous ethnic groups and the dominant culture – especially, perhaps, in North America. But I am not sure that the existence of a formal treaty is all that important in present day multiculturalism, and I suspect that had there been no formal Treaty of Waitangi we would have invented one *ex post*.

How then should minorities identifying with an indigenous, pre-Western culture, relate to modern society? At one level, Maori and Pacific Island people are already very much part of Western New Zealand – they are already Westerners in terms of our constitutional and legal arrangements, and more generally the social, cultural and economic life of New Zealand to which many do, of course, make a very substantial contribution. In many ways New Zealand is a remarkably successful society – our squabbles notwithstanding. While I don't think for a moment we should ignore those difficulties, it would be unfortunate if we lost sight of our successes as a nation and stressed only the problem areas.

But I return to the question about how people identifying with different cultures should live together in one society. In my view it is, as Melanie Phillips has observed, perfectly possible to identify with two cultures: a common civic culture and a private ethnic one (Phillips 1996). This is what in fact we find in New Zealand. We have a broad civic culture of essentially British origin and many minority cultures within it. The taxi driver who took me home from the airport last week was an Indian from Fiji who attends a Hindi speaking cultural group and a Hindu temple. Neighbours of mine are busy rediscovering their supposed Celtic roots, attend Celtic Christian services and lead a band playing Irish and Scottish music. Another neighbour runs a Scottish country dance club. There are many Maori and Pacific Island cultural groups. I could go on.

But all these 'cultures' operate within a broad, common civic culture which is essential if we are all to live together in anything approaching harmony. A common civic culture sets limits on what each individual and group within it can do without creating disharmony. Without a common civic culture, there is, as Phillips has observed, "no reason for minorities to compromise their sometimes mutually incompatible demands. We would end up with the politics of protest, single issue lobbies, acts of violence and tribalism. It is not in the interests of either the majority or the minorities to weaken it" (Phillips 1996). Nicholas Tate, the chief executive of the Schools Curriculum and Assessment Authority for England and Wales, said much the same:

There is a mistaken notion that the way to respond to cultural diversity is to try to bring everything together in some kind of watered down multiculturalism from which all components – majority and minority – lose out. This is a mistake. The best guarantee of strong minority cultures is the existence of a majority culture which is sure of itself, which signals that customs and traditions are things to be valued and which respects other cultures. (Tate 1995)

Yet, there is much in some of the new curriculum documents which appears to seek to undermine our common and, in my view, very successful, civic culture. Why?

Well, what do these observations mean for education?

First, it should give all New Zealand children access to the majority culture so they can take their place within it as full citizens. We are fortunate in New Zealand in having direct access in the English language to some of the finest literature the world has ever known – yet we largely disregard it in our English curriculum. Why? Such literature – and not only that of English speaking writers – wrestles with the problems and passions of being human – the world of understandings, imaginings, meanings, moral and religious beliefs and so on – which, as Oakeshott observed, are intrinsic to the human condition and the knowledge of which introduces us to that condition. *Romeo and Juliet* can be set in modern New York and still command attention because, like other great literature, it is a repository of human experience, representing different ways of observing and explaining the world – not simply a drama involving issues peculiar to England or Italy at the time of Elizabeth I.

All students should have access to this immensely rich cultural inheritance. G. K. Chesterton responded to those who question the relevance of a broad cultural education to the more vocationally oriented in these words:

If anyone asks, as so many are asking: "What is the use of my son learning all about Ancient Athens and remote China and medieval guilds and monasteries, and all sorts of dead or distant things, when he is going to be a plumber in Pimlico?" the answer is obvious enough. The use of it is that he may have some power of comparison, which will not only prevent him from supposing that Pimlico covers the whole planet, but also enables him, while doing full credit to the beauties and virtues of Pimlico, to point out that, here and there, as revealed by alternative experiments, even Pimlico may conceal somewhere a defect.

Many writers, artists, film and television producers appear to feel, to use Saul Bellow's words, that "it is sufficient to cast artificial pearls before real swine. This is how the modern world meets the deepest of human needs – by fraud, demagoguery, opportunism, and profiteering" (Bellow 1994). The hunger for the 'real thing' remains, however. Witness the regular productions of Shakespearean plays, the current widespread appeal of Jane Austen and last week's lavish production of *Aida*. But I fear the new English curriculum is not designed to attend to that hunger of the soul because it has other aims of a 'socialisation' or utilitarian nature.

On the issue of the more utilitarian aims of education, it seems to me that some educationalists are responding to perceived views from the business sector about the need for 'skills' or 'relevance' in education. Older educationalists would rightly have regarded such views as barbaric. But, in my experience, business today is not saying that – it looks for foundational knowledge, evidence of the 'intellectual virtues', and such like. Oakeshott's barbarians are already within the gates.

Secondly, education must not be propaganda designed to change society or to instil within the popular mindset particular but misleading views about the organisation of society. One example of this is the attempt in the drafts of the Social Studies curriculum to entrench the idea of partnership between Maori and the rest of society to such an extent that this at least will become one bit of the world that will not change (Minogue 1996). Another is to break, or at any rate to substantially weaken, New Zealand's cultural links with Britain and Europe, and to imply that our cultural origins lie almost entirely in the South Pacific and neighbouring countries. This contention simply doesn't stand up to any sort of scrutiny and will result in cultural

deprivation with no compensating benefits. Schools should not set out to change society, but to equip students with the knowledge and understanding of the human condition and the world about them that might enable them to make sensible decisions about the course of human affairs later in life.

Thirdly, education must not be indoctrination designed to turn out children with particular attitudes attuned to a predetermined type of society. Education should largely concentrate on knowledge. To instruct is not to proselytise, and in my view there is far too much propaganda and far too little emphasis on instruction in some of the new curricular material. There is also an overweening emphasis on skills which suggests we want to turn out citizens of a particular orientation or, as Ken Minogue put it recently, to "invade the child's mind and to dominate it" (Minogue 1996). Children are, in any case, extraordinarily resistant to such invasions, which is just as well for the human race. We cannot predict the outcome of the education process to any precise degree, not least in terms of the eventual attitudes of individual children. We should be largely content to offer them the "best that has been done and thought", and let the results fall as they will.

Certainly education has a moral basis. Oakeshott's starting point was, as I have already noted, that education "is a difficult engagement of learning ... which calls for humility, patience and courage." This means that the student must have the opportunity to study "in conditions of direction and restraint designed to provoke habits of attention, concentration, exactness in thought and conduct." You will remember that Gramsci also emphasised self-control, and the tedium and suffering to be endured. These habits of mind and intellectual virtues are undermined by indoctrination whether this takes the form of imposing a particular view of historical events or seeking to reconstruct society.

Finally, I would pick-up the excellent question in the invitation about what 'effective education' actually means. In a curious way, I suspect that we would improve education by concentrating less on specific standards of achievement and participation rates and concentrating much more on what education should be. In this process we would be concerned to defend what Oakeshott called the educational engagement from beliefs which threaten to destroy it. This means not encapsulating a distorted form of education immune to attack, but opening it up to more scepticism, more probing, more analysis, less emotion. There would be less resort to simplistic 'left/right' political dichotomies or pedagogical dichotomies such as the 'child versus the curriculum', 'learning areas versus subjects', 'group work versus direct instruction', 'phonics versus whole word', and so on (cf. Woodhead 1995). A much healthier and more effective education system would, in my view, result.

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**PRINCIPALS' CENTRE, UNIVERSITY OF AUCKLAND  
SEMINAR ON IMPLEMENTING THE CURRICULUM**

**CURRICULAR CONFUSION  
THE CASE FOR REVISITING THE  
NEW ZEALAND CURRICULUM FRAMEWORK**

**MICHAEL IRWIN  
POLICY ANALYST  
NEW ZEALAND BUSINESS ROUNDTABLE**

**AUCKLAND  
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## CURRICULAR CONFUSION: THE CASE FOR REVISITING THE NEW ZEALAND CURRICULUM FRAMEWORK

My subject is *The New Zealand Curriculum Framework* (Ministry of Education 1993a) (referred to as *Framework*). *Framework* claims considerable self-importance. In the first sentence of her Foreword to it, the then secretary for education describes it as an "important document", and she commends it for providing:

... the foundation for learning programmes in New Zealand schools for the 1990s and beyond.

I propose to treat it with the importance it claims for itself.

Part of *Framework's* claimed importance lies in its assumed durability – which I interpret to mean that it will be so imbued with self-evident good sense that it will set a widely accepted ethos and overall direction for school activities for many years to come, riding out short-term fluctuations in educational fashion. And this is as it should be. We don't, after all, expect a new curriculum framework every year or two. However, to be durable a framework must be based on a sound philosophy of education, including a wise purpose for schooling and sufficient flexibility to enable the various components to be set within it without distortion. This may well prove to be a tall order in these culturally plural and post-modern times, but at least it is a goal we should aim at.

I would also note that it is now over five years since the draft *National Curriculum of New Zealand – A Discussion Document* was published (Ministry of Education 1991). The final document was published two years later and most of the main curriculum statements fleshing out the framework have now been finalised (English, maths, science, physics, chemistry, biology, technology) or have been published as discussion documents (social studies). Draft statements have yet to be published in only two of the seven essential learning areas identified in the curriculum framework – 'arts' and 'health and physical well-being'.

While much implementation work remains to be undertaken, even where statements have been finalised, it is a good time to review where we have got to and to ask some questions. For example, how well have the framework and the individual curricula stood up to criticism? If we were back five years, in 1991, and had the benefit of hindsight, what would we have done differently?

In 1994 the then minister of education claimed that:

Over the last year, there has been almost universal support – perhaps a unique phenomenon in education – for the Government's curriculum reforms ... .  
(Smith 1994, p. 1)

I suspect the "almost universal support" would be difficult to sustain. The science, English and social studies curricula generated considerable debate through the media and elsewhere. The Education Forum has been a source of sustained analysis and comment on *Framework* and the various subject curricula, and some of its comments have been very critical. But Dr Smith was, I think, correct to the extent that there has not been much criticism overall.

We should be careful not to assume, however, that this relative lack of comment on the curricula reforms is indicative of soundness. There are various reasons why we might not have expected a lot of critical reaction. First, much attention has been

directed elsewhere – school salary bulk funding, tertiary funding and, in more recent times, the new qualifications framework. Secondly, the new curricula do not impact on teachers and teaching as directly as the qualifications framework will on the senior secondary school. Some principals have pointed out to me that they are not overly concerned with deficiencies in various curricula because they have teachers who will still deliver a good curriculum and disregard whatever they dislike in the new ones. I can understand their stance, but from the viewpoint of the schools sector as a whole we should take criticism seriously. Confident, able teachers can make good judgments about what to ignore and can use their own expertise, experience and resources, while less able and inexperienced teachers will rely heavily on the curriculum documents and treat them as blueprints.

A third reason for the lack of criticism is the absence of any professional teacher body able to critique the curricular – and other – school reforms objectively and professionally. I have no doubt that the teacher associations in the various subject areas do a good job within their available resources. The teacher unions are, at present, the only teacher organisations with the necessary funds, but their prime concern is, understandably, the welfare of their members. The unions have referred to the additional administrative burdens consequent on the reforms, and this concern is quite justified.

Fourth, these 'academic' issues are a lot harder to analyse than the more concrete administrative and financial reforms within education. Finally, our education community is very small – there is only a handful of experts in any particular curriculum area – and there isn't the range of view and debate one would expect in a larger educational jurisdiction. Moreover, these are areas in which agencies outside the educational bureaucracy (for example, the Treasury) have little, if any, expertise and, by and large, do not participate to any significant degree in discussion about them. There is, therefore, little contestability of advice to government.

But, whatever the reasons, the result has, in my view, been a lot of straining at the 'gnats' of issues like salary bulk funding and much swallowing of curricular 'camels'.

So how do we go about reviewing those reforms? First, I want to consider what we might expect of a curriculum 'framework' and to comment briefly on the ministry's policy development processes. Second, I will consider what we find in the framework we have been given. In doing so I will draw on some of the curriculum statements to see how *Framework* has been interpreted and applied in the various essential learning areas. Finally, I will outline a different approach which was developed in a report written for the Education Forum in 1994 (Irwin 1994c).

### WHAT SHOULD WE EXPECT TO FIND IN A CURRICULUM 'FRAMEWORK'?

An immediate problem for anyone wanting to ask first order questions like 'Why do we need a framework and what should we expect to find in it?' is that the ministry doesn't appear to consider such issues, or, if it does, it doesn't publish its findings. In its curricular activities, the first published document is usually the first draft of whatever has to be produced. It is as if these first order issues were of no consequence or, perhaps, as if the answers are obvious and unproblematic to any reasonable, right-thinking educationalist. So we have to infer answers to questions about *Framework* such as:

- What are the purposes of schooling that should underlie *Framework*, and how should these purposes influence curricular content?
- Should *Framework* cover all the years of schooling or only, say, those up to the senior secondary school?



- If *Framework* is to be extended to the senior secondary school how should it be related to school summative assessments?<sup>1</sup>
- Should *Framework* provide only a core, leaving schools to expand beyond the core? If a core is to be adopted, how much of the total school curriculum should it cover at the various stages of schooling, and of what should it consist?
- Should *Framework* provide for curricular differentiation or should it assume that all pupils will progress along the same track, albeit at different rates and to different end points?
- Should *Framework* be structured in terms of ages, stages or levels, and how many and which ones?
- How should content be presented? In subjects, learning areas or cross-curricular approaches, and which ones? Should there be only one structure for all subjects, or should content determine the best structure for each subject?
- How is the balance to be drawn between providing firm curricular support for weak teachers and giving freedom to able teachers to extend and innovate?<sup>2</sup>
- How should skills be handled and what is their relationship to curricular content?
- What, if any, assumptions about pedagogy should be adopted and why?

These are some of the many vital questions that should, surely, be asked by those faced with the task of constructing a curriculum framework. While in the case of *Framework* some of the answers are apparent from the text, the reasons for the answers, including why some answers were chosen and not others, are nowhere explicit.

It would be correctly pointed out that the curriculum framework initiative of 1991–93 was itself a development of earlier endeavours, including the curriculum review of 1987 and the draft National Curriculum Statement of 1988 – which themselves had antecedents. For all I know there may be papers somewhere in the archives that address some of these issues. However, I am not aware of any rigorous, high quality examination of the concept of a curriculum framework and how it might best be constructed. Any suggestion that such papers would not be necessary because of the ongoing nature of curriculum policy development is simply not satisfactory because it leaves too many important assumptions unexamined. It would not be acceptable in other policy areas with a long history – taxation for example – and it should not be acceptable in education.

<sup>1</sup> The resolution of this issue is made more difficult by the separation of responsibility for the New Zealand Curriculum Framework from that for the National Qualifications Framework.

<sup>2</sup> This is an important question if it is to be assumed (as surely it should be) that teachers are professionals who can think seriously about their practices and those of other teachers.

## The Ministry's Policy Development Process

I have urged the ministry in the context of the development of its curriculum statements to issue 'thinkpieces' which identify and address issues and options in the light of relevant theoretical and empirical research. Its response was that this is not its practice because, *inter alia*, the education community has consistently expressed satisfaction with "the nature of curriculum development which is emerging through the ministry's policy and contractual arrangements" and the minister, as its client, "endorses [its] policy development model".<sup>3</sup> This response begs the question whether the claimed education community and ministerial satisfaction with the existing policy development process is worth very much if papers analysing and evaluating alternative ways of proceeding have not been first prepared and published.

The process for the individual curricula starts with a letter to individuals and groups inviting them to contribute to the policy development phase. While some very general topics are suggested, no detailed identification and analysis of issues are provided. Policy advisory groups are established to work to terms of reference, set presumably by the ministry, and to make recommendations for the specification of curriculum development contracts. I sought the papers of the social science policy advisory group to discover, if I could, how the decisions for the draft social studies curriculum had been arrived at. I received the minutes of a few meetings and was informed that relevant literature was available to, or well known by, members of the advisory group, that the implications of the literature and analyses were discussed at length, and that all the submissions were carefully considered and key points taken into account. The minutes were brief and concentrated on major points and decisions.

The policy group produced no discussion papers. They did obtain a literature search but no written analysis of the material that had been examined – if any – was made available. There was one brief – two-thirds of a page – piece on the strands which considered, *inter alia*, that their focus should be 'people'. As many curricular areas from art to anthropology, from economics to education, from history to literature, are about 'people', this provided little illumination into whatever the author thought to be an important and defining characteristic of social studies. Perhaps it was again assumed that what was being dealt with was self-evident and/or unproblematic.

Do the other curriculum policy groups work in the same way as the social sciences group? With the exception of technology (a totally new curriculum 'subject') and, perhaps, health and physical well-being,<sup>4</sup> no official thinkpieces of the sort I suggested have, as far as I am aware, been prepared. This method contrasts very sharply with policy development in other branches of government such as the Treasury. Policy changes in areas such as tax, financial management, fiscal responsibility, employment, the role of the Reserve Bank, the state-owned enterprises and many others have been based on extensive analyses including the examination of local and overseas theoretical and empirical research. It has not been assumed that the answers to key issues can be taken for granted. The durability of these reforms and the widespread overseas interest in them owe much to these solid foundations (see Henderson 1996, p. 9; Teece *et al.* 1996). These reforms have, of course, been criticised, but the extent of their intellectual underpinnings has not, as far as I am aware, been seriously questioned.

<sup>3</sup> Ministry letter dated 27 October 1994.

<sup>4</sup> I am aware that for the health and physical well-being learning area a position paper and a literature review have been prepared by a consultant. This is encouraging.

Surely there is no good reason why the education policy should be approached differently.<sup>5</sup> Taking important matters for granted is dangerous – dispensing with proper analysis and informed debate is not acceptable because of the risks that the lack of good policy development procedures may impose on the education of the nation's children. Some might argue that education is special. But on examination this usually means no more than 'education is important' which, of course, is true – as are many other areas of human activity. The educational process may also be particularly hard to quantify, but this means it is more – not less – important to think seriously about what we should be trying to do in education and to face up to the complexities, tensions and ambiguities involved. The importance of 'importance' in education, as in much else, lies in the need to make good decisions and in the risks and costs of poor decisions.

## SOME ASPECTS OF THE NEW ZEALAND CURRICULUM FRAMEWORK

### The General Educational Directions set by *Framework*

A curriculum framework should set an overall direction for the development of school curricula and of the individual subject curricula. What sort of direction does *Framework* set? What sort of ethos does it provide?

The Foreword (p. 1) to *Framework* starts, unfortunately in my view, not with education *per se* but with the perceived needs of the economy. However, having dealt with the "challenges" of the international market place in summary fashion, the Foreword proceeds to tell us that *Framework* is based on the best of our past curriculum experience and the views of educators, the public and business, and that it responds to the need for a learning environment conducive to high standards of educational achievement and "appropriate" personal qualities. It provides a "balance" between the interests of individual students and the requirements of society and the economy. This, of course, begs all sorts of questions such as:

- What constitutes an environment that is conducive to high educational achievement?
- What are "appropriate" personal qualities and who should decide? Appropriate for whom and for what? Appropriate for the economy? In my experience the word 'appropriate' when unqualified is one people use when they are not sure what they do mean – a fudge word.
- Are the curriculum interests of students, society and the economy different, and if so what were the trade-offs and how were they resolved?
- What is the difference in the curricular requirements of the "society" and of its "economy"?

Having raised the prospect of an interesting discussion, the Foreword goes on to assure us that *Framework* is "coherent", that it establishes principles to give direction to all teaching and learning, and that it promotes new emphases important to the

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<sup>5</sup> I must here distinguish between the 'academic' side of education policy development – the curriculum and qualifications issues – and policy issues relating to education funding and administration. The Picot report on education administration, the Titter report on school property, and the Todd report on funding growth in tertiary education and training were solid attempts to address first order issues – attempts which simply do not appear to have been made by those advising the government on the more 'academic' aspects of recent reforms. This is not to infer that the non-academic exercises were wholly successful or that all relevant issues were considered.

country's health and growth. Later we are told it is to apply to all schools, all students and to all years of schooling (p. 3). The substantive part of the Foreword concludes with assurances to the effect that *Framework* is gender inclusive (in a way that suggests that the curriculum needs of girls and boys are very different) and that it acknowledges the value of the Treaty of Waitangi, our "bicultural identity" and "multicultural society". However, and notwithstanding all these prescriptions, schools are to be allowed the freedom to develop programmes that are "appropriate to the needs of their students".

Again important questions arise including:

- What does "coherent" mean in context, and how does it relate to the 'balance' to which reference is made earlier?
- If girls and boys are so different, should we not have separate national curricula for each gender? What would this mean for the curriculum for boys in those areas in which they do not do as well as girls – would it be easier in acknowledgement of their relative intellectual frailty or more demanding in the hope that this might help them close the gap? In any case, do we really have to tell teachers to treat their pupils with justice?
- What exactly is the "value" of the Treaty of Waitangi for schooling, and does it imply positive discrimination in favour of children of a particular ethnic minority? If there is a clash between a Treaty of Waitangi value and an educational value how is the conflict to be resolved?
- What is meant by our "bicultural identity" and "multicultural society", and what is the significance of these concepts to schooling?
- Does the freedom to be given to school teachers to meet the needs of their own pupils allow a school to decide, for example, that:
  - the Treaty of Waitangi has no particular relevance to its curriculum beyond what would in any case be provided on sound educational grounds, or that
  - pupils of both genders and all ethnic backgrounds have much in common, and that what is common is a better starting point for curriculum development and delivery than that which is not.

The answers are not provided, but some indications will emerge – at least implicitly – as we go further through the document.

Overall, what sort of general ethos or direction is indicated from the Foreword to *Framework*? I find it very hard to answer. Requirements and expectations from various quarters – local and international, personal, community and business – are raised, the existence of tensions appears to be acknowledged, and due obeisance made to current, politically correct, emphases. Will it provide the effective and durable learning environment which we should expect from a framework? Certainly not if the early pages of *Framework* are indicative of the whole. They contain no clear direction.

Consider an alternative approach from Hogben's primary syllabus of 1904 which said that the aims of teaching reading were:

... to impart to the pupils the power of fluent reading, with clear enunciation, correct pronunciation, tone, and inflexion, and expression based upon intelligent comprehension of the subject matter; to cultivate a taste for and an

appreciation of good literature; and accordingly to lead the pupils to form a habit of reading good books (cited in Ewing 1970, p. 105).

Of course this sets the direction for only one component, albeit a vital one, of the curriculum and not the whole primary curriculum let alone the whole school curriculum,<sup>6</sup> and there is room for some argument about what constitutes, for example, "good" literature and books. But the contrast is striking in terms of clarity and intelligibility and the lack of reference to non-educational concepts (the Treaty of Waitangi, biculturalism etc.) or external requirements (such as the international market place). I very much prefer it.

The contrast between Hogben and *Framework* illustrates the additional burdens and responsibilities that have been placed on schools and their teachers in recent decades, and the confusion and curricular complexities that have resulted from this. A prime 'first-order' question is precisely this issue of what it is that schools should be expected to offer and what should be left to parents, communities and community organisations. The boundary of responsibility has been shifted in recent times. It is questionable whether in all cases the responsibilities are proper functions of schools and, indeed, whether moving the boundaries is in the long-term interests of children and the community in general. It is a problem that reflects the politicised nature of schooling, and the fact that many groups in society consider that the state in its provision of schooling should attend to their concerns.

### The Structure of *Framework*

The structure of *Framework* consists of the principles, essential learning areas and skills, attitudes and values, assessment, and the structure to be followed in the development of national curriculum statements.

### The Principles

Rather than consider each of the nine principles, I will focus only on the two premises which are said to form their basis:

- the individual student is at the centre of all teaching and learning; and
- the curriculum for all students will be of the highest quality.

The first premise is reflected in numerous references in the principles about the need to "enable" and "empower" students and to "respond" to each student's learning needs. The premise is, of course, grossly inflated. As I have pointed out elsewhere:

Is it not the case that we all live in a complex society of relationships, rights, duties and obligations, with an extensive culture and an ongoing history? It is hard to see how we can prepare young people to take their proper place in such a society if the central premise of their education is that each and everyone of them is at the centre of all teaching and learning (Irwin 1994a, p. 4).

As for focusing on individual student needs, I have pointed out that:

The problem with a curriculum focused on needs, whether those of society, the economy or the individual student, is that it is based on changing subjective perceptions. It acknowledges few, if any, external benchmarks against which education can be judged (Irwin 1994c, p. 7).

<sup>6</sup> Also, there wasn't a curriculum 'framework' in Hogben's time.

The logical conclusion of the emphases on individual students and their individual needs is highly individualised curricula, an idea which sits uncomfortably with a *national* curriculum which aims to set "national directions" and "consistency in classroom programmes" (*Framework* p. 3).

This concentration on the individual student may have encouraged the authors of the new science curriculum (Ministry of Education 1993b, p. 10) to make the extraordinary statement that science learning is enhanced:

... within a supportive atmosphere of mutual respect where all the experiences, ideas, and beliefs which students bring into the learning situation are acknowledged as a basis for learning.

Science is certainly built on the shoulders of the giants who have gone before, but our new science curriculum appears to be saying that it is built on the shoulders of all. One of the striking things about scientific endeavour is that it requires the scientist to forgo the comfort of previous ideas and beliefs in a single-minded, humble pursuit of the truth about the world which, when found, may disappoint, or embarrass and confound those existing "ideas and beliefs". Further, as Kelly (1995) has pointed out, "[extending constructivist research on learning] into an educational ideology that perceives the concept of social-construction as more important than that of scientific rationality can seriously undermine both effective learning and the transmission of a valid portrayal of science."

The principles descend to the absurd when, for example, the school curriculum is required to "respect ... the values of all students" – a requirement for moral relativism which is, in any case, contrary to insistence elsewhere in *Framework* (p. 21) that particular 'values' such as honesty and reliability be reinforced.

We are not told explicitly the criteria by which we should recognise "highest quality" in the curriculum, but presumably they include being "gender-inclusive, non-racist, and non-discriminatory, ..." and having an substantial element of biculturalism and multiculturalism. Much of this is, I think, mistaken at best and, at worst, encourages the wrong sort of education – one that seeks to inculcate certain views rather than give students the knowledge and concepts with which to arrive at their own opinions. The required emphases may, for example, discourage critical engagement with historical accounts involving Maori and women in New Zealand society. They reflect current politically correct emphases which, in their present form, may well not prove durable.

What is not included in the principles is, perhaps, even more remarkable than what is. For example, we find no clear reference to learning that is desirable in its own right quite irrespective of the felt needs of society, the economy or the realisation of social ideals<sup>7</sup>. This is a quite astonishing and deplorable omission in a national curriculum.

Again there is no reference to wisdom. In a secular state school the beginning of wisdom is not, I suppose, to be found in "the fear of the Lord" (Proverbs 1:7) but, as T. S. Eliot observed, it would be a pity if we overlooked the possibilities of education as a means of acquiring it (Eliot 1962, p. 99). These possibilities include the transmission of the riches of our western cultural inheritance and opening up to each new generation the thoughts of the great minds of the past as they wrestled with the tensions, ambiguities and uncertainties of the human predicament. An exposure to such works would help pupils to develop powers of discrimination – not in crass

<sup>7</sup> *Framework* does require the school curriculum to encourage positive attitudes to all areas of learning (p. 23). In context this appears to mean encouragement to work hard rather than to respect knowledge *per se* or, for example, to appreciate good literature – see the earlier quote from Hogben.

racial, gender or ethnic terms but as between good and evil, the noble and the ugly, the eternal and the ephemeral, truth and propaganda, and so on (Irwin 1994c).

The premises and principles do not, in my view, constitute a sound prescription for a durable curriculum framework. In seeking to 'be all things to all people' they confirm the legitimacy of the expectations that press in on schools from every side. Rather than riding out short-term fluctuations in intellectual fashions they are in danger of being submerged by them. On this second point, A. E. Housman warned us of :

... the house of bondage, and of the soul which is so fast in prison that it cannot get forth; which commands no outlook upon the past or the future, but believes that the fashion of the present, unlike all fashions heretofore, will endure perpetually, and that its own flimsy tabernacle of second-hand opinions is a habitation for everlasting.<sup>8</sup>

### *Essential Learning Areas*

We do not know why *Framework* discusses content in terms of learning areas rather than subjects or why the seven chosen are considered the best ones for a national curriculum. In fact *Framework* adopts a threefold approach of learning areas, subjects (subjects may contribute to learning areas) and, in the case of technology (a learning area which "has application to all subjects of the curriculum" p. 12), a cross-curricular approach.

The main advantage I can see in learning areas is that they might assist in ensuring breadth in the curriculum. But, even if this were to be a decisive argument in favour of them, why were the particular seven areas chosen? Why not, for example, 'communication', 'analytics', 'aesthetics' and 'ethics'? Indeed, why not a modern version of the medieval trivium and the quadrivium, as that remarkable woman Dorothy Sayers (Sayers 1948) once advocated for schools? Obviously there has to be some way of breaking down and organising the school curriculum and the essential learning areas approach may be as good as any other as a first stage. In practice, most learning areas collapse into subjects, notwithstanding rhetoric to the contrary in *Framework*.

Pupils are required to take a "broad and balanced" (or "balanced and broad") education in their first ten years, which means taking courses within all seven areas (pp. 8-9). In the final three years the curriculum is only to be "balanced", though a "broad and balanced" education is still to be available and this is, I think, a sensible solution. In year 11 "breadth" seems to mean that pupils are to take six subjects, and here we do find a mandatory core of English or Maori, mathematics and a science subject. Education in years 12 to 13 may be in "greater depth", but it is unclear what 'depth' and 'balanced' means for these years or even whether the two concepts are compatible. In fact it is not entirely clear what any of these concepts mean in practice. Given also the vagueness of the description of the learning areas and the reference to integrated, topical and thematic approaches (p. 8), 'balance' and 'breadth' would seem to allow a wide range of interpretation.

But, 'balance', 'breadth' and 'depth' are not the only concepts of importance. It is also necessary to consider the time to be given to each of the learning areas at various stages. A major weakness in *Framework* is the lack of any indication of this, and its omission will lead to problems in implementation, especially those of an overcrowded curriculum (see Howson 1994, p. 4).

The descriptions of the individual learning areas (pp. 10-16) are a mixture of the useful, the obvious, the unclear and the unhelpful. Problems with these descriptions

<sup>8</sup> From Preface to *Manilius I*.

have been carried through to the curriculum statements. I will just give examples from three learning areas.

**In language**, *Framework* requires that, in "selecting authors and texts, schools will have regard to gender balance and to the inclusion of a range of cultural perspectives." We find this concept of gender balance in the choice of materials in the English and social studies curricula. Education Forum submissions have pointed out that:

- ... if the aim is to give the same amount of attention to recorded female and male activities in social studies programmes, massive omissions and purges of major areas of human experience would be required. Whether or not this state of affairs should now be viewed as 'just', the fact is that the overwhelming bulk of activity recorded in many fields of human endeavour has been carried out by males (Education Forum 1995); and
- ... any attempt to balance the choice of [literary] texts as between male and female authors [in the English curriculum] would be to misrepresent literary history since women writers were relatively few prior to the twentieth century. That it is fashionable to deplore this fact does nothing to alter it, nor to supply a shortfall of good pre-twentieth century texts by women" (Education Forum 1994a).

Attempts to define **technology** in curricular terms have been fraught with enormous problems in England and Wales, and the same seems to be the case here. While everyone is clear that our lives are profoundly affected by technology and it is widely accepted that it should, therefore, be represented in the school curriculum, it has been far from clear how it should be defined and delivered. Its relationship with science needs to be clarified (see Jenkins 1994) and its scope kept within reasonable bounds. As it is, *Framework's* definition of technology seems too broad for the school curriculum and may have contributed to what appears to me to be an over-ambitious curriculum with an excess of strands whose scope stretches into wider territory, such as social anthropology, threatening the integrity and coherence of the 'subject'<sup>9</sup> (see Education Forum 1994b, and Jenkins 1994).

*Framework's* definition of the social sciences has, in my view, prolonged the confusion about what comprises **social studies** and gives it a spurious respectability. Its definition of the social sciences refers to history, geography and economics and seems to infer that social studies is whatever does not fall within them, that is, "global issues", the environment, biculturalism, multiculturalism, social justice, values clarification, and the like (Irwin 1994b). The drafts of the social studies curriculum reflect this confusion and echo the 'political correctness' of *Framework's* principles. To the moral relativism already noted, we must now add the cultural relativism of the draft social studies statements. The Education Forum submission on the first draft expressed strong concern with, *inter alia*:

- its implication that self-directed activity by unprepared students, without the clear guidance of well-informed teachers, is the most effective way in which knowledge can be acquired;
- its reluctance to confront the unattractive features of traditional Polynesian culture, the grave limitations of pre-industrial cultures everywhere and the positive (not just negative) aspects of European settlement;
- its suggestion that only Maori perspectives on Maori culture are valid; and

<sup>9</sup> The number of strands was reduced from six in the draft technology statement to three in the final statement. However, there are eight substrands in the final statement which together seem to cover much the same material as in the draft.



- its requirement that teachers value traditional Maori family relationships and forms of land ownership, but not the typical nuclear family of those of British descent and modern forms of property ownership which have been so germane to economic and social progress (Education Forum 1995).

Too much of *Framework* appears to be aimed at social reconstruction of one sort or another. Take for example the requirement that "concern for social justice ... be fostered" (p. 14). *Social* justice these days appears to refer to government interventions in the welfare area, but whether they are just or constitute justice is another matter entirely. A more profitable approach could be to test the concept of justice in a variety of situations and cultural contexts, so that students can pose questions and seek to answer them. They might conclude, for example, that the justice of social welfare benefits is far from self evident and that, to the extent that it breaks the link between cause and effect, it may undermine virtue (Minogue 1995) (but then virtue, like courtesy, is a concept that does not appear in *Framework*).

What we need, I suggest, is not an education that "fosters" a particular institutional arrangement, but the mental training that enables pupils to think through what might constitute justice and injustice, sense and nonsense, truth and propaganda, the beautiful and the ugly, and so on. As Bertrand Russell observed:

If we respected the rights of children, we should educate them to give them the knowledge and the mental habits required for forming independent opinions; but education as a political institution endeavours to form habits and to circumscribe knowledge in such a way as to make one set of opinions inevitable" (Russell 1961).

### Essential Skills

The eight groupings of essential skills have considerable prominence in *Framework*, and several of the subject curricula (for example, the statements for English, social studies, mathematics, and technology) assure the reader that they will provide opportunity for the development of several of these skills. In fact, the social studies curriculum (both the original and revised versions) categorises many modes of learning, including critical thinking, creativity and problem solving, as 'skills'.

*Framework's* treatment of 'skills' is naive and unhelpful in my view. In its usual basic sense, a skill implies a specific capacity which can be perfected through practice and exercise, such as juggling, throwing or dribbling a ball, neat handwriting, playing a note correctly, finding a place on a map given its latitude and longitude, and so on. There is certainly an important element of practice involved in critical thinking, creativity and other higher order modes of thinking, but referring to them as skills may be extremely misleading. At the very least skills of a mechanical and specific practice type need to be differentiated from capacities developed in very different ways. This lack of differentiation in the National Qualifications Framework is one of the more serious problems with that model.

The development of critical thinking requires sustained periods of reasoning that conforms to rules of logic and standards of excellence. These standards are not generic but are intrinsic to distinctive forms of knowledge. A developed capacity for critical thought in mathematics does not make one critically thoughtful as a historian or a literary critic, for example. There may be some transfer between forms of knowledge, and studies in formal logic, deduction and induction may be of some value. However, in general, students do not acquire critical thought in one form of knowledge by applying generic skills developed in other activities, but rather through in-depth and systematic studies within that form of knowledge (see Education Forum 1996).

## Curriculum Statements

In one short passage of just over a page (pp. 22–23) *Framework* lays down the structure for curriculum statements consisting of strands, aims and objectives. A large number of issues is involved, and the following discussion of them is necessarily brief.

First, the same structure is to apply to all statements. This one-structure-fits-all approach is highly problematic. The dangers include those of dividing what should be kept together and homogenising what should be kept separate. There has been a tendency to invent unnecessary strands, for example the curious 'visual language' strand in the English curriculum (Education Forum 1994a). As already noted, the technology curriculum arguably has an excess of strands or substrands (Education Forum 1994b). In any case, surely the educationally correct approach is to consider the material to be delivered and *then* to work out how it might best be structured in curriculum terms.

Second, the reduction of strands into achievement aims and achievement objectives presents again the potential problems of unnecessary and unhelpful division and homogenisation which can undermine intellectual coherence. The danger, as I see it, lies more in unnecessary division. On this point J H Newman wrote:

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 (Newman 1891).<sup>10</sup>

Moreover, these curriculum statements are to "specify clear learning outcomes *against which students' achievements can be assessed*" (p. 5, emphasis added). Of course we should endeavour to be as clear as possible *ex ante* about what schooling aims to achieve and to assess *ex post* what it has achieved. But if 'learning outcomes' are to be so clearly defined that pupils, teachers and 'third parties' can all understand them at a glance, then curriculum documents in any subject will have to be reduced to small fragments, each in itself trivial. The assumption in this competency-based approach that we can precisely predetermine educational outcomes for assessment purposes also bedevils the qualifications framework.<sup>11</sup>

Third, the statements are to cover all learning. There is no distinction between what might be considered 'core' and what might be considered optional. The lack of assistance in this matter compounds the potential for curriculum overload.

Fourth, the objectives in all curricula are to be set out in a number of levels, usually eight, to indicate progression and continuity from year 1 to year 13. Important issues are involved here including how to order material in which there may not be a natural hierarchy of complexity or difficulty. The curricula are to go right through to school exit. Why should this be necessary when school exit examinations will determine senior school curricula? UK authorities found their 10 level scale unnecessarily complex and prescriptive, and discontinued its use beyond year 9. And why levels and not stages or ages? We do not know. And why eight levels? Eight seems far too few to provide motivation to students and information to parents, schools and teachers. But then more levels would make the structure even more complex – there

<sup>10</sup> Consider also Gandalf in Tolkien's *Lord of the Rings*: "He who breaks a thing to find out what it is has left the path of wisdom". Those seeking to establish 'seamless' education by breaking up knowledge and skills into thousands of unit standards (each with two or more 'elements' and various other ingredients) might profitably consider whether this is the "path of wisdom" – and indeed whether 'seamlessness' can be achieved by increasing the number of seams.

<sup>11</sup> For a recent discussion of competency-based assessment in the United Kingdom see Wolf 1995. For an examination of unit standards in the National Qualifications Framework see Irwin *et al.* 1995.

are problems in both directions. And why no curricular differentiation – there being only one curricular pathway in each subject for all students? Should the curriculum for mathematics, for example, be the same for all students whether they are going to leave school at 16 or going on to read maths at university (Howson 1994, pp. 11–12)? My own view is that the lack of provision for curricular differentiation is a major weakness in *Framework*.

These and other issues (including the important issue of pedagogy) have been raised and discussed at greater length in various Education Forum reports (see bibliography). The point I wish to stress here is that *Framework* assumes answers to a great many issues which do not appear to have been fully and explicitly analysed.

## AN ALTERNATIVE APPROACH

The duty of any critic is to outline an alternative approach. Such an approach is discussed at some length in a report for the Education Forum in 1994 (Irwin 1994c).

I do not believe that there is any 'one best' curriculum structure – inevitably there are trade-offs to be made. The optimal structure may vary between countries. Some countries which appear to achieve high educational standards have very prescriptive curricula while others also appear to do well with minimal central direction. What we in New Zealand have to do is work through the complex issues and make the best judgment we can about where the optimal solution for us lies.

My own view is that the optimal solution for New Zealand schooling at all levels is much more limited in scope than the one we now have. It would involve *inter alia*:

- a concern for the individual student within a broad historical and cultural context, and for both personal development and the acquisition of subject knowledge;
- the concept of a core curriculum the statements for which would set out in simple direct language the essential knowledge, understandings and skills that should be acquired at each form level up to and including Form 4. It would leave an increasing proportion of the school curriculum to be determined within the school (for example, one-third in the primary years rising to half in the junior secondary years);
- stress on the importance of developing coherent programmes (not a multiplicity of achievement aims and objectives) and practical guidance about how such programmes might be constructed; and
- the recognition of different abilities and post-school aspirations among secondary children, and the need for students from Form 5 onwards to choose suitable pathways, each pathway having several options constructed as complete programmes of study. There would be opportunities to switch pathways. Secondary schools would be allowed to specialise in quality education for technically or vocationally inclined students, that is, curricular differentiation by school.<sup>12</sup>

<sup>12</sup> See article by John Gray, "Britain's Painful Dilemma over Schools" in the Guardian Weekly, 29 September 1996, for a discussion of comprehensiveness versus curricular differentiation by school in Britain.

## CONCLUDING REMARKS

In my view, New Zealand missed a great opportunity between 1991 and 1993 to construct an educationally sound, flexible curriculum framework. We did not do so for various reasons, including political requirements that may have been unrealistic in educational and timing terms, weaknesses in a ministry of education that was understaffed (it lost much of its curriculum expertise in various restructurings) and overloaded with work, and the lack of an in-depth contribution from the teaching profession that was reeling from the Picot and other reforms and lacked (and still lacks) its own professional body with a capacity for independent quality research.

As it is, we have a poorly constructed framework which has contributed to many of the unsatisfactory aspects of the curriculum statements. Two related emphases are particularly disturbing: the emphasis on teaching children what to think and not how to think, and the use of schooling to serve external purposes such as social reconstruction. Dorothy Sayers wrote in what would now be politically incorrect language:

For the sole true end of education is simply this: to teach men how to learn for themselves; and whatever instruction fails to do this is effort spent in vain (Sayers 1948, p. 263).<sup>13</sup>

By this test, significant parts of what is advocated in *Framework* and related documents will be "effort spent in vain". I know many schools and teachers will reject these emphases, but it is highly disturbing that we should find them in official documents. They are most conspicuous in the social studies proposals and in the English curriculum. It is to be hoped that these points are made in submissions on the revised draft of the social studies curriculum statement.

I have argued elsewhere (Irwin 1996) that we have a strange mixture in education of, on the one hand, moral relativism which requires the suspension of judgment and, on the other hand, moral passion which demands acceptance of *particular* judgments and denounces those who question them as dishonest or worse. It is what Michael Polanyi called "moral inversion" (Polanyi 1958, pp. 232ff), and it comes about when moral passion is uprooted from any authoritative external ground and is hence less open to critical philosophical analysis (Torrance 1975). These "homeless moral passions" (Polanyi, *ibid.*) carry with them a strong sense of righteousness and moral superiority, evident in passionate judgments against social evils, including racism and sexism.

This moral passion requires a political power base if it is to exert force and achieve its ends. In the education area it is the lever of the national curriculum that, if captured, can mostly easily exert that force, which is why it is important that this lever is handled with great wisdom. I hope it will be apparent enough that I am not arguing that any curriculum should endorse sexism or racism. On the contrary, concern for justice and for the removal or diminution of sexual or racial discrimination are proper causes. My concern is that when such causes become detached from external reference points, such as the concepts of truth and intrinsic worth (the religious among us would say transcendent moral obligation), they can lead to distortions and indoctrination.

The last five years of curricular development have provided much from which we should learn. In my view, we should revisit, reassess and reconstruct *Framework* in

<sup>13</sup> Some hundred years earlier, Mill had warned that:

A general State education is a mere contrivance for moulding people to be exactly like one another. ... in proportion as it is efficient and successful, it establishes a despotism over the mind, leading by natural tendency to one over the body (Mill, 1859).

the light of that experience. A national education curriculum is too important a matter to be left in an unsatisfactory state. The Education Forum has provided a substantial and challenging analytical contribution to such an exercise in the form of its various reports and submissions. I would like to think the teaching profession (or groups within it) will also take up the challenge, come to its own considered opinion, publish it and make representations to the educational authorities in line with its analysis. This is, I believe, essential for public schooling in a participatory democracy.

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## MISCELLANEOUS



**IIR '97 RETIREMENT SAVINGS SUMMIT**

**AN ECONOMIC ANALYSIS OF  
COMPULSORY SAVINGS**

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

**WELLINGTON  
29 MAY 1997**

# AN ECONOMIC ANALYSIS OF COMPULSORY SAVINGS

## 1 INTRODUCTION

This paper focuses on the economic effects of a compulsory savings scheme. It looks first at some of the economic relationships between savings, economic growth and national sovereignty. Section 3 presents empirical evidence on savings performance in New Zealand and some countries with compulsory savings schemes. Section 4 considers some policy issues from the perspective of the business sector, including the financial services industry, and section 5 makes some concluding comments. An annex contains some more detailed material on these issues.

## 2 CONSUMPTION, SAVING AND ECONOMIC GROWTH

### What are we Trying to Maximise?

Material standards of living, including in retirement, are basically dependent on consumption opportunities. Consumption is the end-purpose of economic activity; it is the aggregate we want to maximise. Savings is deferred consumption; it is simply a means to an end. We save in order to spread consumption over time or to increase consumption in the future through profitable investments. The sustainable consumption opportunities of the community, including people in retirement, are essentially determined by the productivity and growth performance of the economy.

### Do Higher Savings Lead to Higher Growth?

Fifty years ago economists were concerned about excessive saving – the so-called Keynesian problem of under-consumption. Today some people fret about countries saving too little. In fact, excessive savings and investment are as damaging to welfare (consumption possibilities) as the reverse. A successful effort to raise national savings and investment ratios might have little effect on the rate of economic growth. A basic growth model suggests the sustainable growth rate would not be altered. Instead there would be a one-off increase in per capita income. At the same time consumption per head could fall because of the greater burden of capital depreciation. Policies for growth need to be broadly based.

### Can Governments Change National Savings Ratios?

National savings comprise savings by households, firms and governments. Firms and governments have no money of their own: their assets and liabilities are owned by individuals. Given people's consumption plans, it is plausible that changes in one component of savings would be offset to some extent by changes in others. Furthermore, attempts to increase one form of household savings (retirement savings) by regulation would be likely to result in reductions in other forms of household savings (for example, home ownership). Most economists believe the main influence the government can exert on national savings is through its own savings or dissavings (operating surpluses or deficits). Taxes and welfare policies may be additional influences.

### Would Higher Domestic Savings Reduce Reliance on Foreign Investment and Increase New Zealand's Sovereignty?

If domestic savings are lower than domestic investment, the result by definition is a current account deficit and, if maintained over time, an increase in both foreign liabilities and domestic assets to service them. There is nothing untoward about this situation if overall policy settings are sound. Nor is there any automatic relationship

between domestic savings and the current account balance. As shown in the annex, higher domestic savings could be offset by changes in investment or net imports which would leave the current account position unchanged. Any problem of external indebtedness is best addressed by sound stabilisation (monetary and fiscal) policies and microeconomic reforms to improve international competitiveness. The net stock of claims by foreigners on New Zealand can only be reduced by running current account surpluses, not by restrictions on asset sales or foreign investment. Economic sovereignty is primarily a matter of whether a country's overall economic framework is sound and robust, and its economy flexible and competitive.

### What is the 'Right' Level of Saving?

The answer to this question is straightforward. Central planners do not have the information to know. Instead it is the level that emerges if households are free to divide their income between current and future consumption in accordance with their own preferences in a relatively undistorted economic environment, free of inflation and fiscal imbalances. It is likely to be futile, if not counter-productive, for governments to try to interfere with the sum of the decisions of all the units making up the community as they go about their affairs.

## 3 EMPIRICAL EVIDENCE ON SAVINGS

### General

As theory suggests, there is no close relationship between national savings (and investment) ratios and economic performance. The US savings ratio has been low for many decades. The savings ratios in the former Eastern bloc countries were among the highest in the world. The theory was that 'primitive socialist accumulation' would enable them to pay for rapid industrialisation in the absence of foreign capital and allow the Soviet Union to overtake the West. New Zealand's savings and investment ratios have been around or above the Organisation for Economic Cooperation and Development (OECD) averages but until recently our growth rate has been the lowest in the OECD area. Clearly other factors, including the efficiency of savings and investment, are more important determinants of economic growth.

Moreover, studies suggest that the causal connection between savings and growth may not run in the direction that is commonly supposed. The World Bank in its report *The East Asian Miracle* concluded that "growth drives savings rather than the other way around". In a separate examination of four Asian countries, other researchers came up with a fairly unambiguous finding: "In all four countries [Japan, South Korea, Singapore and Hong Kong] growth was high early and savings was high later". In South Korea, for example, growth averaged 6.1 percent during the period 1960-74 while the average savings rate was only 10.4 percent. In the subsequent period, 1977-87, savings averaged 27.8 percent and growth only 5.3 percent.<sup>1</sup>

Some of the economic relationships considered thus far can be studied for three countries that have adopted compulsory savings schemes.

### The Case of Australia

Australia has had a compulsory superannuation scheme since the early 1990s. Despite this, household savings have been falling steadily and are now less than 3 percent of disposable income. The national savings rate has fallen too: at 16.7 percent of gross domestic product (GDP) in 1994, it was well below the average for the first half of the 1980s. New Zealand's savings rate in 1994 was 20.4 percent, nearly four percentage points higher than Australia's. What has clearly happened in Australia is that there

<sup>1</sup> See 'Savings equals growth? Ain't necessarily so', *Australian Financial Review*, March 13 1997.

has been a massive switch in savings into superannuation and life insurance and away from forms such as repayment of home mortgages, but no increase in the total. Moreover, compulsory saving has not prevented large current account deficits and a build-up of external debt.

### The Case of Chile

Chile introduced a compulsory savings scheme against a background of astronomical rates of inflation, a collapse of private savings and an inadequate and unaffordable public safety net. Its domestic savings rate has risen from under 5 percent to around 25 percent. However, contrary to the common belief about the effects of pension reform, empirical research suggests that its contribution to private saving was small or even negative.<sup>2</sup> The important contributions to Chile's higher savings rate appear to be the increase in disposable income with economic growth and the increase in public saving resulting from sounder fiscal policies.

### The Case of Singapore

Similar evidence exists for Singapore. Its Central Provident Fund (CPF) was established in 1955, and Singapore has had one of the highest savings rates in the world. However, while the CPF may have been a factor in Singapore's rising savings rate until the early 1980s, recent research suggests that the more important explanations are demographic factors, the rapid growth of private disposable income and the high level of budgetary saving.<sup>3</sup> Withdrawals are allowed from the CPF for a range of purposes. Only 15.9 percent of withdrawals are at age 55 (the age at which funds may be withdrawn for retirement purposes), and housing investments account for the bulk (66.6 percent) of the withdrawals. CPF saving is clearly highly substitutable for voluntary private saving, and there appears in recent years to have been a full offset between CPF and non-CPF saving.

## 4 IMPLICATIONS FOR BUSINESS AND THE FINANCIAL SERVICES INDUSTRY

### General

Because compulsory savings schemes do little or nothing to increase overall national savings, they cannot make any significant contribution to economic growth even if there were a positive and causal link between total national savings and growth. Moreover, such schemes clearly distort savings and investment patterns in a number of ways, and are therefore likely to have negative effects on growth, and on welfare more generally. The interests of the business sector are in the development of a dynamic economy with increasing output and incomes per capita. These interests are the same as those of the retired elderly, who require access to a growing volume of real goods and services as their numbers increase. Interventionist policies such as compulsory savings reduce economic growth.

<sup>2</sup> Holzmann, Robert, 'Pension Reform, Financial Market Development, and Economic Growth: Preliminary Evidence from Chile', IMF Working Paper, August 1996.

<sup>3</sup> Carling, Robert and Oestreicher, Geoffrey, 'Singapore's Central Provident Fund', IMF Paper on Policy Analysis and Assessment, December 1995.

## Implications for Capital Raising

In order to reduce administrative complexities and lock-in savings until retirement, approved forms of compulsory savings have to be confined to a relatively narrow range of institutions, principally superannuation funds, life offices and banks. Investments in small businesses, farms and property, for example, are unlikely to be approved. Large superannuation funds are able to invest in major publicly listed companies, whose access to capital may therefore be improved with a compulsory regime, but they find it difficult to cope with the transactions costs of investments in small businesses, farms or direct property. Capital raising in these cases, and others such as venture capital, would be likely to become more difficult. Compulsory savings would almost certainly lead to pressures to re-regulate the financial sector, resulting in higher costs for all raisers of capital.

## Implications for Savings Institutions

At first sight a compulsory savings scheme might be thought to benefit approved financial institutions by channelling a higher proportion of national savings through them, although it would disadvantage other financial intermediaries. However, providers of retirement income products are likely to experience significant growth in any case given the growing recognition of the need for private provision. Moreover, a reduction in economic growth under a compulsory scheme might reduce the volume of savings attracted by such institutions despite their higher market share. They would also be subject to the costs of increased regulation, high levels of transfers between schemes, a good deal of marginally profitable or unprofitable business, and frequent changes to the rules of the scheme. The last are inevitable with changing economic and political circumstances – some 2,000 changes to Australia's scheme have been reported since its inception. Changes in tax rates and inflation also affect scheme costs and benefits. Future governments could not be relied upon to maintain a hands-off attitude to fund investments – the proportion invested overseas, for example, could well become a political issue. There would also be political pressures to depart from an actuarially fair basis for provisions such as annuities, which would have no justification on commercial or efficiency grounds. All these factors would create an uncertain environment both for savers and institutions, contrary to the intentions of the policy.

## 5 CONCLUSION

The analysis in this paper suggests that proposals for compulsory superannuation to pursue the goals of national savings, sovereignty, economic growth and retirement income provision are misconceived. New Zealand does not have a savings problem by OECD standards. The environment for savings has been improved substantially in recent years with lower inflation, deregulation of the financial system, lower income taxes and the introduction of goods and services tax, moves towards a more restricted welfare safety net, and an end to public sector dissavings. These moves should be maintained or extended: the government's proposals to increase spending, reduce the need for self-provision of health, education and retirement income savings, and reduce its own savings are moves in the wrong direction. Similarly, it is surely egregious in itself and of dubious efficacy in terms of providing security in retirement to take away or reduce people's freedom to apply their savings to such purposes as:

- education;
- investments in a business or a farm;
- buying a home or repaying a mortgage; and
- consumption at times of great need.

Instead of a narrow focus on savings, the focus of retirement income policies should be on economic growth. As one study put it:

The key to providing high incomes in retirement is the pursuit of policies promoting high economic growth. Policies to this end rarely are focused just on retirement and superannuation issues but cover taxation, government spending, government regulations, labour market arrangements, and the incentive and reward structures facing individuals, private business enterprises and governments. With an expanding economy, most people should be able to self-provide for their retirement income, and should face incentives to save and to consume which are level and fair across their lifetime: the basic role of a government pension is to provide a bottom safety net against the problem of aged poverty.<sup>4</sup>

There are no grounds for arguing that the present public safety net is 'unsustainable'. The available studies indicate that it would require only quite modest increases in tax rates to sustain it even in the long term. Moreover, what matters for sustainability is not the increase in the proportion of elderly in the population but its relationship to the productivity of the economy. The central scenario of the New Zealand Institute of Economic Research's (NZIER) 1995 assessment was based on the conservative assumption of a long-term growth rate of 1.8 percent per annum.<sup>5</sup> This is far below the medium-term growth rates – of 3.5–5 percent in the case of National and 6 percent in the case of New Zealand First – targeted by the coalition government. In the long term, the economy ought to have the potential to achieve an annual growth rate considerably higher than that assumed by the NZIER, given sound policies. Those calling the present scheme unsustainable seem to lack confidence in the country's future economic management.

Of course to argue that the present safety net is sustainable is not the same as arguing that the current policies are the best possible ones. A good case can be made, for example, for allowing the eligibility age to rise as life expectancy increases, for the adoption of targeting on Australian lines and for aligning the rate to the lower level of other long-term benefits for a future cohort of retirees, as the Royal Commission on Social Policy recommended. Similarly, private superannuation planning would be encouraged by general growth-oriented policies including reductions to income tax rates, which would reduce the current tax bias against savings and towards tax-favoured investments such as home ownership and higher education. Such policies should be pursued in the period ahead, within the framework of the 1993 Accord on Retirement Income Policies, if the September referendum on compulsory superannuation fails.

<sup>4</sup> Anstie, R., Freebairn, J. and Porter, M., *Superannuation and Government Aged Pension Schemes for a Dynamic Economy*, Centre of Policy Studies, Melbourne, May 1989.

<sup>5</sup> New Zealand Institute of Economic Research, *The Fiscal Impacts of an Aging Population*, Office of the Retirement Commissioner, 1995.

## COMPULSORY SUPERANNUATION

### 1 Introduction

- 1.1 This annex analyses the economic justification for compulsory superannuation. Although the proposed scheme has not yet been announced, it is possible to assess the merits of compulsory superannuation by examining the principles involved. The scheme that is to be put to the electorate may differ in detail from that assumed in this paper, but the thrust of its conclusions is unlikely to be altered.
- 1.2 The paper addresses the role of the government in relation to retirement incomes (section 2) and scrutinises the reasons advanced for compulsory superannuation (section 3). Arguments for opposing compulsory superannuation are further developed in section 4. The conclusions are presented in section 5.

### 2 The Government's Role in Relation to the Provision of Income in Retirement

- 2.1 The government's prime roles in advancing overall national welfare are to:
- promote general economic and other policies that encourage the efficient use of resources, including price stability and full employment, and provide opportunities for all citizens. A wealthier country is better placed to support the elderly and other dependent groups, at least in absolute terms. Efficient labour, education and training markets assist people to support themselves during their working lives and to provide for their retirement;
  - encourage effort, innovation and risk taking by providing a predictable policy environment and by ensuring that such activities are not stifled by high taxes and welfare arrangements that undermine the acceptance of personal responsibility; and
  - provide a safety net for people who are unable to support themselves and who are not supported through private means. This role applies to people of all ages – it is not confined to the elderly.
- 2.2 The living standards of people in retirement are largely determined by their ability to consume goods and services. Retirees cannot consume their savings directly. Their savings must be used to buy goods and services that are produced by New Zealand's working-age population or by workers of other countries (imports). The British economist, Nicholas Barr, expressed this point in these terms:

Pensioners do not eat pound note 'butties' – they use the pound notes to purchase consumption, and it is consumption that matters.<sup>1</sup>

<sup>1</sup> Barr, Nicholas (1979), 'Myths My Grandpa Taught Me', *Three Banks Review*, No. 124, p. 35.

- 2.3 If retirees try to acquire more goods and services than workers are prepared to make available through their savings, pressure on the balance of payments will increase and/or inflation will be higher than otherwise. For this reason, policies that improve efficiency and thereby enable future output to be increased should be the focus of the government's policy on the provision of income in retirement. An emphasis on savings is misplaced.
- 2.4 An increasing elderly population can continue to be supported at current income levels only by:
- constraining current consumption and investing overseas with a view to financing imports in the future; and/or
  - constraining the consumption of the working-age population in future, for example through higher taxes, to make goods and services available to retirees; and/or
  - boosting future output by increasing the working-age population relative to the dependent population (through immigration and by lowering the impact on work decisions of New Zealand Superannuation) and by raising productivity. New Zealand Superannuation encourages people to withdraw from the labour force. There was a noticeable reduction in labour force participation by people over 60 years of age following the introduction of National Superannuation. Labour force participation by people aged 60 to 65 years has increased since the policy of gradually raising the qualifying age for New Zealand Superannuation was adopted.
- 2.5 Immigration can help to modify demographic trends and assist in providing consumption in retirement for an aging population because:
- immigrants with skills, ideas, a strong work ethic and capital help to foster competition, entrepreneurship, innovation and an outward-looking economy; and
  - immigrants of working age help to reduce the ratio of dependents to workers. Many countries in Asia and elsewhere have much younger populations than most OECD countries.
- 2.6 In the short term an increase in savings can only be achieved by reducing current consumption.

### 3 **Reasons Advanced for Compulsory Superannuation**

- 3.1 *National savings are inadequate.* It is argued that New Zealand has a shortfall of savings which constrains investment and hence the growth of output. This proposition does not justify a compulsory superannuation scheme because:
- there is no compelling evidence that aggregate savings are too low. A large part of the differences among countries' savings ratios is a statistical illusion. Measurement problems are severe, and national accounting data need to be adjusted for factors such as the treatment of consumer durables, pensions, the actuarial surpluses or deficits of government welfare funds, and age structures.



Provided sound fiscal and monetary policies are pursued, the level of savings will generally reflect people's preferences for current and future consumption (that is, their discount rates). The level of investment will reflect judgments by individuals and private firms on profitable investment opportunities in New Zealand relative to the rest of the world. The welfare of savers and investors would be diminished if their preferences were interfered with other than for valid public policy reasons;

- it is more likely to alter the form of savings than the aggregate amount of savings. Many people would divert savings that would otherwise be made to the compulsory scheme without increasing their total savings. Australia's experience with a compulsory superannuation scheme supports this view. According to OECD data, its gross savings ratio has not increased during the 1990s. The ratio stood at 16.7 percent in 1994 and in each of the three years to 1994 was lower than at any time since at least 1977, raising the possibility that Australia's savings ratio has actually fallen. The attached report from *The Economist* of 23 November 1996 summarises research which found that sound fiscal, capital market and other policies, and not its superannuation scheme, largely account for Chile's growth in savings;
- the government should focus on all savings rather than savings for a single purpose if it wishes to raise the aggregate level of savings. One efficient way of encouraging such savings would be to reduce income tax relative to GST. Unlike GST, income tax tends to discourage savings relative to current consumption. Lower government spending and hence lower taxes would help to promote savings. Excessive welfare programmes also discourage savings. The high saving rates recorded by some Asian countries may well be explained by low taxes, limited welfare support and high growth.

The shift from operating deficits to surpluses in the government's accounts and the establishment of a low inflation environment have been positive for savings. OECD data suggest that our gross savings ratio has increased from 14.9 percent in 1990 to 21.0 percent in 1993. This is the highest ratio recorded in 16 years and is over 4 percentage points above Australia's ratio. While the savings ratio would generally increase during the expansionary phase of the economic cycle, the policy changes referred to may have contributed to a cyclically-adjusted rise in the ratio. Westpac-FPG research suggests that the household savings ratio is also increasing;

- there are no valid grounds to favour long-term savings relative to other savings. Financial markets enable savings of different durations to be matched with the lending terms desired by borrowers. This is illustrated by an investment in a company. Although the ownership of a share may change many times within a year, the company retains the capital initially subscribed. This allows long-term capital spending to be financed by short-term investors;
- higher domestic savings do not automatically translate into increased output. Savings must be invested. Higher investment will only increase output in the future if it yields an appropriate return. Some centrally planned countries like Albania, Russia and China recorded high savings rates for certain periods, essentially by constraining the supply of goods and services, and an abysmal growth in output. On the other hand, the United States and South Korea were countries that

are problems in both directions. And why no curricular differentiation – there being only one curricular pathway in each subject for all students? Should the curriculum for mathematics, for example, be the same for all students whether they are going to leave school at 16 or going on to read maths at university (Howson 1994, pp. 11–12)? My own view is that the lack of provision for curricular differentiation is a major weakness in *Framework*.

These and other issues (including the important issue of pedagogy) have been raised and discussed at greater length in various Education Forum reports (see bibliography). The point I wish to stress here is that *Framework* assumes answers to a great many issues which do not appear to have been fully and explicitly analysed.

## AN ALTERNATIVE APPROACH

The duty of any critic is to outline an alternative approach. Such an approach is discussed at some length in a report for the Education Forum in 1994 (Irwin 1994c).

I do not believe that there is any 'one best' curriculum structure – inevitably there are trade-offs to be made. The optimal structure may vary between countries. Some countries which appear to achieve high educational standards have very prescriptive curricula while others also appear to do well with minimal central direction. What we in New Zealand have to do is work through the complex issues and make the best judgment we can about where the optimal solution for us lies.

My own view is that the optimal solution for New Zealand schooling at all levels is much more limited in scope than the one we now have. It would involve *inter alia*:

- a concern for the individual student within a broad historical and cultural context, and for both personal development and the acquisition of subject knowledge;
- the concept of a core curriculum the statements for which would set out in simple direct language the essential knowledge, understandings and skills that should be acquired at each form level up to and including Form 4. It would leave an increasing proportion of the school curriculum to be determined within the school (for example, one-third in the primary years rising to half in the junior secondary years);
- stress on the importance of developing coherent programmes (not a multiplicity of achievement aims and objectives) and practical guidance about how such programmes might be constructed; and
- the recognition of different abilities and post-school aspirations among secondary children, and the need for students from Form 5 onwards to choose suitable pathways, each pathway having several options constructed as complete programmes of study. There would be opportunities to switch pathways. Secondary schools would be allowed to specialise in quality education for technically or vocationally inclined students, that is, curricular differentiation by school.<sup>12</sup>

<sup>12</sup> See article by John Gray, "Britain's Painful Dilemma over Schools" in the Guardian Weekly, 29 September 1996, for a discussion of comprehensiveness versus curricular differentiation by school in Britain.

## CONCLUDING REMARKS

In my view, New Zealand missed a great opportunity between 1991 and 1993 to construct an educationally sound, flexible curriculum framework. We did not do so for various reasons, including political requirements that may have been unrealistic in educational and timing terms, weaknesses in a ministry of education that was understaffed (it lost much of its curriculum expertise in various restructurings) and overloaded with work, and the lack of an in-depth contribution from the teaching profession that was reeling from the Picot and other reforms and lacked (and still lacks) its own professional body with a capacity for independent quality research.

As it is, we have a poorly constructed framework which has contributed to many of the unsatisfactory aspects of the curriculum statements. Two related emphases are particularly disturbing: the emphasis on teaching children what to think and not how to think, and the use of schooling to serve external purposes such as social reconstruction. Dorothy Sayers wrote in what would now be politically incorrect language:

For the sole true end of education is simply this: to teach men how to learn for themselves; and whatever instruction fails to do this is effort spent in vain (Sayers 1948, p. 263).<sup>13</sup>

By this test, significant parts of what is advocated in *Framework* and related documents will be "effort spent in vain". I know many schools and teachers will reject these emphases, but it is highly disturbing that we should find them in official documents. They are most conspicuous in the social studies proposals and in the English curriculum. It is to be hoped that these points are made in submissions on the revised draft of the social studies curriculum statement.

I have argued elsewhere (Irwin 1996) that we have a strange mixture in education of, on the one hand, moral relativism which requires the suspension of judgment and, on the other hand, moral passion which demands acceptance of *particular* judgments and denounces those who question them as dishonest or worse. It is what Michael Polanyi called "moral inversion" (Polanyi 1958, pp. 232ff), and it comes about when moral passion is uprooted from any authoritative external ground and is hence less open to critical philosophical analysis (Torrance 1975). These "homeless moral passions" (Polanyi, *ibid.*) carry with them a strong sense of righteousness and moral superiority, evident in passionate judgments against social evils, including racism and sexism.

This moral passion requires a political power base if it is to exert force and achieve its ends. In the education area it is the lever of the national curriculum that, if captured, can mostly easily exert that force, which is why it is important that this lever is handled with great wisdom. I hope it will be apparent enough that I am not arguing that any curriculum should endorse sexism or racism. On the contrary, concern for justice and for the removal or diminution of sexual or racial discrimination are proper causes. My concern is that when such causes become detached from external reference points, such as the concepts of truth and intrinsic worth (the religious among us would say transcendent moral obligation), they can lead to distortions and indoctrination.

The last five years of curricular development have provided much from which we should learn. In my view, we should revisit, reassess and reconstruct *Framework* in

<sup>13</sup> Some hundred years earlier, Mill had warned that:

A general State education is a mere contrivance for moulding people to be exactly like one another. ... in proportion as it is efficient and successful, it establishes a despotism over the mind, leading by natural tendency to one over the body (Mill, 1859).

the light of that experience. A national education curriculum is too important a matter to be left in an unsatisfactory state. The Education Forum has provided a substantial and challenging analytical contribution to such an exercise in the form of its various reports and submissions. I would like to think the teaching profession (or groups within it) will also take up the challenge, come to its own considered opinion, publish it and make representations to the educational authorities in line with its analysis. This is, I believe, essential for public schooling in a participatory democracy.

## ACKNOWLEDGEMENTS

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## MISCELLANEOUS

**IIR '97 RETIREMENT SAVINGS SUMMIT**

**AN ECONOMIC ANALYSIS OF  
COMPULSORY SAVINGS**

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

**WELLINGTON  
29 MAY 1997**



# AN ECONOMIC ANALYSIS OF COMPULSORY SAVINGS

## 1 INTRODUCTION

This paper focuses on the economic effects of a compulsory savings scheme. It looks first at some of the economic relationships between savings, economic growth and national sovereignty. Section 3 presents empirical evidence on savings performance in New Zealand and some countries with compulsory savings schemes. Section 4 considers some policy issues from the perspective of the business sector, including the financial services industry, and section 5 makes some concluding comments. An annex contains some more detailed material on these issues.

## 2 CONSUMPTION, SAVING AND ECONOMIC GROWTH

### What are we Trying to Maximise?

Material standards of living, including in retirement, are basically dependent on consumption opportunities. Consumption is the end-purpose of economic activity; it is the aggregate we want to maximise. Savings is deferred consumption; it is simply a means to an end. We save in order to spread consumption over time or to increase consumption in the future through profitable investments. The sustainable consumption opportunities of the community, including people in retirement, are essentially determined by the productivity and growth performance of the economy.

### Do Higher Savings Lead to Higher Growth?

Fifty years ago economists were concerned about excessive saving – the so-called Keynesian problem of under-consumption. Today some people fret about countries saving too little. In fact, excessive savings and investment are as damaging to welfare (consumption possibilities) as the reverse. A successful effort to raise national savings and investment ratios might have little effect on the rate of economic growth. A basic growth model suggests the sustainable growth rate would not be altered. Instead there would be a one-off increase in per capita income. At the same time consumption per head could fall because of the greater burden of capital depreciation. Policies for growth need to be broadly based.

### Can Governments Change National Savings Ratios?

National savings comprise savings by households, firms and governments. Firms and governments have no money of their own: their assets and liabilities are owned by individuals. Given people's consumption plans, it is plausible that changes in one component of savings would be offset to some extent by changes in others. Furthermore, attempts to increase one form of household savings (retirement savings) by regulation would be likely to result in reductions in other forms of household savings (for example, home ownership). Most economists believe the main influence the government can exert on national savings is through its own savings or dissavings (operating surpluses or deficits). Taxes and welfare policies may be additional influences.

### Would Higher Domestic Savings Reduce Reliance on Foreign Investment and Increase New Zealand's Sovereignty?

If domestic savings are lower than domestic investment, the result by definition is a current account deficit and, if maintained over time, an increase in both foreign liabilities and domestic assets to service them. There is nothing untoward about this situation if overall policy settings are sound. Nor is there any automatic relationship

between domestic savings and the current account balance. As shown in the annex, higher domestic savings could be offset by changes in investment or net imports which would leave the current account position unchanged. Any problem of external indebtedness is best addressed by sound stabilisation (monetary and fiscal) policies and microeconomic reforms to improve international competitiveness. The net stock of claims by foreigners on New Zealand can only be reduced by running current account surpluses, not by restrictions on asset sales or foreign investment. Economic sovereignty is primarily a matter of whether a country's overall economic framework is sound and robust, and its economy flexible and competitive.

### What is the 'Right' Level of Saving?

The answer to this question is straightforward. Central planners do not have the information to know. Instead it is the level that emerges if households are free to divide their income between current and future consumption in accordance with their own preferences in a relatively undistorted economic environment, free of inflation and fiscal imbalances. It is likely to be futile, if not counter-productive, for governments to try to interfere with the sum of the decisions of all the units making up the community as they go about their affairs.

## 3 EMPIRICAL EVIDENCE ON SAVINGS

### General

As theory suggests, there is no close relationship between national savings (and investment) ratios and economic performance. The US savings ratio has been low for many decades. The savings ratios in the former Eastern bloc countries were among the highest in the world. The theory was that 'primitive socialist accumulation' would enable them to pay for rapid industrialisation in the absence of foreign capital and allow the Soviet Union to overtake the West. New Zealand's savings and investment ratios have been around or above the Organisation for Economic Cooperation and Development (OECD) averages but until recently our growth rate has been the lowest in the OECD area. Clearly other factors, including the efficiency of savings and investment, are more important determinants of economic growth.

Moreover, studies suggest that the causal connection between savings and growth may not run in the direction that is commonly supposed. The World Bank in its report *The East Asian Miracle* concluded that "growth drives savings rather than the other way around". In a separate examination of four Asian countries, other researchers came up with a fairly unambiguous finding: "In all four countries [Japan, South Korea, Singapore and Hong Kong] growth was high early and savings was high later". In South Korea, for example, growth averaged 6.1 percent during the period 1960-74 while the average savings rate was only 10.4 percent. In the subsequent period, 1977-87, savings averaged 27.8 percent and growth only 5.3 percent.<sup>1</sup>

Some of the economic relationships considered thus far can be studied for three countries that have adopted compulsory savings schemes.

### The Case of Australia

Australia has had a compulsory superannuation scheme since the early 1990s. Despite this, household savings have been falling steadily and are now less than 3 percent of disposable income. The national savings rate has fallen too: at 16.7 percent of gross domestic product (GDP) in 1994, it was well below the average for the first half of the 1980s. New Zealand's savings rate in 1994 was 20.4 percent, nearly four percentage points higher than Australia's. What has clearly happened in Australia is that there

<sup>1</sup> See 'Savings equals growth? Ain't necessarily so', *Australian Financial Review*, March 13 1997.

has been a massive switch in savings into superannuation and life insurance and away from forms such as repayment of home mortgages, but no increase in the total. Moreover, compulsory saving has not prevented large current account deficits and a build-up of external debt.

### The Case of Chile

Chile introduced a compulsory savings scheme against a background of astronomical rates of inflation, a collapse of private savings and an inadequate and unaffordable public safety net. Its domestic savings rate has risen from under 5 percent to around 25 percent. However, contrary to the common belief about the effects of pension reform, empirical research suggests that its contribution to private saving was small or even negative.<sup>2</sup> The important contributions to Chile's higher savings rate appear to be the increase in disposable income with economic growth and the increase in public saving resulting from sounder fiscal policies.

### The Case of Singapore

Similar evidence exists for Singapore. Its Central Provident Fund (CPF) was established in 1955, and Singapore has had one of the highest savings rates in the world. However, while the CPF may have been a factor in Singapore's rising savings rate until the early 1980s, recent research suggests that the more important explanations are demographic factors, the rapid growth of private disposable income and the high level of budgetary saving.<sup>3</sup> Withdrawals are allowed from the CPF for a range of purposes. Only 15.9 percent of withdrawals are at age 55 (the age at which funds may be withdrawn for retirement purposes), and housing investments account for the bulk (66.6 percent) of the withdrawals. CPF saving is clearly highly substitutable for voluntary private saving, and there appears in recent years to have been a full offset between CPF and non-CPF saving.

## 4 IMPLICATIONS FOR BUSINESS AND THE FINANCIAL SERVICES INDUSTRY

### General

Because compulsory savings schemes do little or nothing to increase overall national savings, they cannot make any significant contribution to economic growth even if there were a positive and causal link between total national savings and growth. Moreover, such schemes clearly distort savings and investment patterns in a number of ways, and are therefore likely to have negative effects on growth, and on welfare more generally. The interests of the business sector are in the development of a dynamic economy with increasing output and incomes per capita. These interests are the same as those of the retired elderly, who require access to a growing volume of real goods and services as their numbers increase. Interventionist policies such as compulsory savings reduce economic growth.

<sup>2</sup> Holzmann, Robert, 'Pension Reform, Financial Market Development, and Economic Growth: Preliminary Evidence from Chile', IMF Working Paper, August 1996.

<sup>3</sup> Carling, Robert and Oestreicher, Geoffrey, 'Singapore's Central Provident Fund', IMF Paper on Policy Analysis and Assessment, December 1995.

## Implications for Capital Raising

In order to reduce administrative complexities and lock-in savings until retirement, approved forms of compulsory savings have to be confined to a relatively narrow range of institutions, principally superannuation funds, life offices and banks. Investments in small businesses, farms and property, for example, are unlikely to be approved. Large superannuation funds are able to invest in major publicly listed companies, whose access to capital may therefore be improved with a compulsory regime, but they find it difficult to cope with the transactions costs of investments in small businesses, farms or direct property. Capital raising in these cases, and others such as venture capital, would be likely to become more difficult. Compulsory savings would almost certainly lead to pressures to re-regulate the financial sector, resulting in higher costs for all raisers of capital.

## Implications for Savings Institutions

At first sight a compulsory savings scheme might be thought to benefit approved financial institutions by channelling a higher proportion of national savings through them, although it would disadvantage other financial intermediaries. However, providers of retirement income products are likely to experience significant growth in any case given the growing recognition of the need for private provision. Moreover, a reduction in economic growth under a compulsory scheme might reduce the volume of savings attracted by such institutions despite their higher market share. They would also be subject to the costs of increased regulation, high levels of transfers between schemes, a good deal of marginally profitable or unprofitable business, and frequent changes to the rules of the scheme. The last are inevitable with changing economic and political circumstances – some 2,000 changes to Australia's scheme have been reported since its inception. Changes in tax rates and inflation also affect scheme costs and benefits. Future governments could not be relied upon to maintain a hands-off attitude to fund investments – the proportion invested overseas, for example, could well become a political issue. There would also be political pressures to depart from an actuarially fair basis for provisions such as annuities, which would have no justification on commercial or efficiency grounds. All these factors would create an uncertain environment both for savers and institutions, contrary to the intentions of the policy.

## 5 CONCLUSION

The analysis in this paper suggests that proposals for compulsory superannuation to pursue the goals of national savings, sovereignty, economic growth and retirement income provision are misconceived. New Zealand does not have a savings problem by OECD standards. The environment for savings has been improved substantially in recent years with lower inflation, deregulation of the financial system, lower income taxes and the introduction of goods and services tax, moves towards a more restricted welfare safety net, and an end to public sector dissavings. These moves should be maintained or extended: the government's proposals to increase spending, reduce the need for self-provision of health, education and retirement income savings, and reduce its own savings are moves in the wrong direction. Similarly, it is surely egregious in itself and of dubious efficacy in terms of providing security in retirement to take away or reduce people's freedom to apply their savings to such purposes as:

- education;
- investments in a business or a farm;
- buying a home or repaying a mortgage; and
- consumption at times of great need.

Instead of a narrow focus on savings, the focus of retirement income policies should be on economic growth. As one study put it:

The key to providing high incomes in retirement is the pursuit of policies promoting high economic growth. Policies to this end rarely are focused just on retirement and superannuation issues but cover taxation, government spending, government regulations, labour market arrangements, and the incentive and reward structures facing individuals, private business enterprises and governments. With an expanding economy, most people should be able to self-provide for their retirement income, and should face incentives to save and to consume which are level and fair across their lifetime: the basic role of a government pension is to provide a bottom safety net against the problem of aged poverty.<sup>4</sup>

There are no grounds for arguing that the present public safety net is 'unsustainable'. The available studies indicate that it would require only quite modest increases in tax rates to sustain it even in the long term. Moreover, what matters for sustainability is not the increase in the proportion of elderly in the population but its relationship to the productivity of the economy. The central scenario of the New Zealand Institute of Economic Research's (NZIER) 1995 assessment was based on the conservative assumption of a long-term growth rate of 1.8 percent per annum.<sup>5</sup> This is far below the medium-term growth rates – of 3.5–5 percent in the case of National and 6 percent in the case of New Zealand First – targeted by the coalition government. In the long term, the economy ought to have the potential to achieve an annual growth rate considerably higher than that assumed by the NZIER, given sound policies. Those calling the present scheme unsustainable seem to lack confidence in the country's future economic management.

Of course to argue that the present safety net is sustainable is not the same as arguing that the current policies are the best possible ones. A good case can be made, for example, for allowing the eligibility age to rise as life expectancy increases, for the adoption of targeting on Australian lines and for aligning the rate to the lower level of other long-term benefits for a future cohort of retirees, as the Royal Commission on Social Policy recommended. Similarly, private superannuation planning would be encouraged by general growth-oriented policies including reductions to income tax rates, which would reduce the current tax bias against savings and towards tax-favoured investments such as home ownership and higher education. Such policies should be pursued in the period ahead, within the framework of the 1993 Accord on Retirement Income Policies, if the September referendum on compulsory superannuation fails.

<sup>4</sup> Anstie, R., Freebairn, J. and Porter, M., *Superannuation and Government Aged Pension Schemes for a Dynamic Economy*, Centre of Policy Studies, Melbourne, May 1989.

<sup>5</sup> New Zealand Institute of Economic Research, *The Fiscal Impacts of an Aging Population*, Office of the Retirement Commissioner, 1995.

## COMPULSORY SUPERANNUATION

### 1 Introduction

- 1.1 This annex analyses the economic justification for compulsory superannuation. Although the proposed scheme has not yet been announced, it is possible to assess the merits of compulsory superannuation by examining the principles involved. The scheme that is to be put to the electorate may differ in detail from that assumed in this paper, but the thrust of its conclusions is unlikely to be altered.
- 1.2 The paper addresses the role of the government in relation to retirement incomes (section 2) and scrutinises the reasons advanced for compulsory superannuation (section 3). Arguments for opposing compulsory superannuation are further developed in section 4. The conclusions are presented in section 5.

### 2 The Government's Role in Relation to the Provision of Income in Retirement

- 2.1 The government's prime roles in advancing overall national welfare are to:
- promote general economic and other policies that encourage the efficient use of resources, including price stability and full employment, and provide opportunities for all citizens. A wealthier country is better placed to support the elderly and other dependent groups, at least in absolute terms. Efficient labour, education and training markets assist people to support themselves during their working lives and to provide for their retirement;
  - encourage effort, innovation and risk taking by providing a predictable policy environment and by ensuring that such activities are not stifled by high taxes and welfare arrangements that undermine the acceptance of personal responsibility; and
  - provide a safety net for people who are unable to support themselves and who are not supported through private means. This role applies to people of all ages – it is not confined to the elderly.
- 2.2 The living standards of people in retirement are largely determined by their ability to consume goods and services. Retirees cannot consume their savings directly. Their savings must be used to buy goods and services that are produced by New Zealand's working-age population or by workers of other countries (imports). The British economist, Nicholas Barr, expressed this point in these terms:

Pensioners do not eat pound note 'butties' – they use the pound notes to purchase consumption, and it is consumption that matters.<sup>1</sup>

<sup>1</sup> Barr, Nicholas (1979), 'Myths My Grandpa Taught Me', *Three Banks Review*, No. 124, p. 35.

- 2.3 If retirees try to acquire more goods and services than workers are prepared to make available through their savings, pressure on the balance of payments will increase and/or inflation will be higher than otherwise. For this reason, policies that improve efficiency and thereby enable future output to be increased should be the focus of the government's policy on the provision of income in retirement. An emphasis on savings is misplaced.
- 2.4 An increasing elderly population can continue to be supported at current income levels only by:
- constraining current consumption and investing overseas with a view to financing imports in the future; and/or
  - constraining the consumption of the working-age population in future, for example through higher taxes, to make goods and services available to retirees; and/or
  - boosting future output by increasing the working-age population relative to the dependent population (through immigration and by lowering the impact on work decisions of New Zealand Superannuation) and by raising productivity. New Zealand Superannuation encourages people to withdraw from the labour force. There was a noticeable reduction in labour force participation by people over 60 years of age following the introduction of National Superannuation. Labour force participation by people aged 60 to 65 years has increased since the policy of gradually raising the qualifying age for New Zealand Superannuation was adopted.
- 2.5 Immigration can help to modify demographic trends and assist in providing consumption in retirement for an aging population because:
- immigrants with skills, ideas, a strong work ethic and capital help to foster competition, entrepreneurship, innovation and an outward-looking economy; and
  - immigrants of working age help to reduce the ratio of dependents to workers. Many countries in Asia and elsewhere have much younger populations than most OECD countries.
- 2.6 In the short term an increase in savings can only be achieved by reducing current consumption.

### 3 Reasons Advanced for Compulsory Superannuation

- 3.1 *National savings are inadequate.* It is argued that New Zealand has a shortfall of savings which constrains investment and hence the growth of output. This proposition does not justify a compulsory superannuation scheme because:
- there is no compelling evidence that aggregate savings are too low. A large part of the differences among countries' savings ratios is a statistical illusion. Measurement problems are severe, and national accounting data need to be adjusted for factors such as the treatment of consumer durables, pensions, the actuarial surpluses or deficits of government welfare funds, and age structures.

Provided sound fiscal and monetary policies are pursued, the level of savings will generally reflect people's preferences for current and future consumption (that is, their discount rates). The level of investment will reflect judgments by individuals and private firms on profitable investment opportunities in New Zealand relative to the rest of the world. The welfare of savers and investors would be diminished if their preferences were interfered with other than for valid public policy reasons;

- it is more likely to alter the form of savings than the aggregate amount of savings. Many people would divert savings that would otherwise be made to the compulsory scheme without increasing their total savings. Australia's experience with a compulsory superannuation scheme supports this view. According to OECD data, its gross savings ratio has not increased during the 1990s. The ratio stood at 16.7 percent in 1994 and in each of the three years to 1994 was lower than at any time since at least 1977, raising the possibility that Australia's savings ratio has actually fallen. The attached report from *The Economist* of 23 November 1996 summarises research which found that sound fiscal, capital market and other policies, and not its superannuation scheme, largely account for Chile's growth in savings;
- the government should focus on all savings rather than savings for a single purpose if it wishes to raise the aggregate level of savings. One efficient way of encouraging such savings would be to reduce income tax relative to GST. Unlike GST, income tax tends to discourage savings relative to current consumption. Lower government spending and hence lower taxes would help to promote savings. Excessive welfare programmes also discourage savings. The high saving rates recorded by some Asian countries may well be explained by low taxes, limited welfare support and high growth.

The shift from operating deficits to surpluses in the government's accounts and the establishment of a low inflation environment have been positive for savings. OECD data suggest that our gross savings ratio has increased from 14.9 percent in 1990 to 21.0 percent in 1993. This is the highest ratio recorded in 16 years and is over 4 percentage points above Australia's ratio. While the savings ratio would generally increase during the expansionary phase of the economic cycle, the policy changes referred to may have contributed to a cyclically-adjusted rise in the ratio. Westpac-FPG research suggests that the household savings ratio is also increasing;

- there are no valid grounds to favour long-term savings relative to other savings. Financial markets enable savings of different durations to be matched with the lending terms desired by borrowers. This is illustrated by an investment in a company. Although the ownership of a share may change many times within a year, the company retains the capital initially subscribed. This allows long-term capital spending to be financed by short-term investors;
- higher domestic savings do not automatically translate into increased output. Savings must be invested. Higher investment will only increase output in the future if it yields an appropriate return. Some centrally planned countries like Albania, Russia and China recorded high savings rates for certain periods, essentially by constraining the supply of goods and services, and an abysmal growth in output. On the other hand, the United States and South Korea were countries that



achieved high growth with relatively low savings. New Zealand has undertaken considerable investment but it has not always obtained commensurate increments to its output. Some of the most poorly directed investment arose from inefficient government policies and investment programmes. Moreover, higher levels of investment, if sustained, imply larger provisions for depreciation or the consumption of capital. They may lead to an increase in the level of per capita income but not to an increase in the rate of growth; and

- the proposed compulsory superannuation scheme is, at most, likely to have a modest impact on our gross savings ratio. Eight percent of household income (the proposed contribution rate) amounted to about \$4.5 billion in 1994/95. Household income is broadly defined to include compensation of employees, entrepreneurial income, property income other than imputed interest, Accident Rehabilitation and Compensation Insurance Corporation benefits, social welfare payments other than New Zealand Superannuation and veterans' pensions, and other social assistance grants. If gross savings had increased by this amount, the savings ratio would have risen by about five percentage points. This calculation is based on extremely favourable and implausible assumptions, including no change in the behaviour of citizens, no substitution of other forms of savings, a very broad definition of income that includes interest, dividends and income support paid to the working-age population, and no change in economic activity in response to a large cut in disposable incomes. More realistic assumptions suggest that, at most, a small impact on savings might be obtained but at a high cost.

### 3.2 With a compulsory superannuation scheme:

- the return on related investments may be reduced for the following reasons:
  - the preferences of managers of institutional funds may differ from those of contributors. Institutions tend to invest in established enterprises such as companies with shares listed on the stock exchange. Small businesses and start-up ventures, which often struggle for funding because of the risk involved, tend to be financed in other ways. Business owners, farmers and other entrepreneurs may find it more difficult to obtain external funding and at the same time their savings would be diverted through compulsory superannuation to institutionally funded investments. Innovation and risk taking could be impaired. Large, established enterprises would be encouraged relative to small and new businesses,
  - the incentive to manage superannuation schemes efficiently and to be responsive to the wishes of savers would be diminished. While savers may be able to choose among registered schemes, fund managers would face less competition than at present. Moreover, the incentive for savers to monitor fund managers would be impaired with a mandatory scheme;
- investment in human capital may decline. If compulsory superannuation, including government top-ups, provided people with a higher income in retirement than desired, they may invest less in education and training; and

- people may become more dependent on the state. A compulsory superannuation scheme leads to moral hazard problems for the government. Moral hazard arises because the contributor may change his or her behaviour in unintended ways. Some contributors might be encouraged to save as little as possible in the expectation that the government will eventually top up their contributions.

3.3 Furthermore, an alleged shortage of domestic savings does not make it necessary to raise interest rates to attract foreign investors as is sometimes suggested. In a closed economy, the interest rate is determined by the demand for investment and the supply of domestic savings. If the domestic rate of interest is above the risk-adjusted world rate of interest, because there are many profitable investment opportunities relative to available domestic savings, allowing foreign investment would reduce it. On the other hand, if the domestic rate of interest were below the world rate of interest in the closed economy case, it would rise not because inward foreign investment were allowed but because New Zealanders could increase their return by investing their savings abroad. Thus inward foreign investment does not raise New Zealand's interest rate but it could lower it if investment exceeds the amount of savings residents are prepared to supply at the risk-adjusted world interest rate.

3.4 *Foreign investment threatens the sovereignty of New Zealand.* It has been argued that compulsory superannuation is required to raise domestic savings and reduce our reliance on foreign investment. This justification for a compulsory scheme is not supported in the economic literature. It is based on a mistaken view of the role that foreign investment plays in a modern economy. Relevant arguments are as follows:

- New Zealanders will only sell land and other assets to foreigners if the latter offer a price at least as attractive as that offered by residents. Foreign investment therefore increases the wealth of New Zealanders by bidding up the price of assets;
- foreign investors will only pay a higher price for assets than domestic buyers if they can put them to a more productive use than other bidders. This increases output and raises incomes;
- foreign investment promotes competition and innovation, facilitates the introduction of new skills and ideas, and generally strengthens international linkages. It may, for example, provide access to research and development and to export markets. In these ways foreign investment reduces costs and raises productivity. There is overwhelming evidence that open goods and capital markets improve efficiency;
- an increase in savings would not necessarily reduce inward foreign investment. It could be reflected in higher investment in New Zealand, offshore investment and/or higher overseas reserves. These outcomes are derived from the national income accounting framework which requires that the following identities hold at all times:
  - (1) investment - savings = imports - exports
  - (2) imports - exports = capital inflows - capital outflows + the change in overseas reserves

$$(3) \quad \text{investment} - \text{savings} = \text{capital inflows} - \text{capital outflows} \\ + \text{the change in overseas reserves}$$

Equation 1 shows that an increase in savings must be accompanied by higher investment and/or a reduction in net imports (that is, imports less exports or the current account deficit). If the adjustment is entirely through higher investment, there would be no change in the current or the capital accounts and foreign investment would not be reduced (equations 1 and 2). If net imports adjust, then inward foreign investment (capital inflows), capital outflows (outward foreign investment) and/or reserves must change by an equivalent amount (equation 2). If the full adjustment were reflected through capital outflows or overseas reserves, there would be no change in foreign investment in New Zealand;

- foreign institutions will only lend to private enterprises that are deemed to be creditworthy. If they make a mistake they bear the cost. However, in the case of overseas borrowing by the government, the merits of the particular project to be financed are of little importance to the lender because his or her key security is the government's power to impose taxes; and
- the view that foreign investors will act against the interests of New Zealanders is mistaken. Adam Smith's observation on the motivation of domestic producers applies equally to foreign owned enterprises:

It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.<sup>2</sup>

3.5 *Myopia*. It is argued that people make inadequate provision for retirement because their time horizon is too short. The myopia argument is unsustainable for the following reasons:

- adults of sound mind can generally be assumed to act rationally in the sense that they do not systematically make the same mistakes. They learn from experience. The presumption that people usually act in their best interests is at the heart of economic analysis. The abandonment of the assumption of rationality does not overcome the perceived problem. How could a government that reflects the interests of voters be assumed to act rationally if most voters are deemed to behave irrationally?;
- retirement is a predictable event. Risk is an everyday occurrence which people begin to learn to live with from a young age. Research has shown that people generally act rationally in respect of well known risks that have a relatively high probability of occurring. The probability of reaching retirement for a person of working age is much higher than the risk that a person's home will burn down during his or her working life, yet 97.5 percent of homes in New Zealand are insured against loss from fire. This is despite the availability of safety net assistance (such as income support or the accommodation supplement);

<sup>2</sup>

Smith, Adam (1937), *An Inquiry into the Nature and Causes of the Wealth of Nations*, Random House, New York, p.14 (first published in 1776).

- people may prefer to consume now rather than in the future. The view that people are saving too little assumes that there is an optimal balance between current and future consumption which is known. But people have different preferences and face varied circumstances, and they may make a variety of arrangements to provide income in retirement. They may accumulate savings, build up human capital and physical assets, extend their working life and help younger family members to gain educational qualifications in return for support in their retirement.

The proposed compulsory superannuation scheme is likely to require people to save sufficient income to provide a pension broadly equal to New Zealand Superannuation. This would imply a doubling in retirement income for some people if New Zealand Superannuation were retained on a universal basis, and would require up to 16 percent of pre-tax income to be committed to the funding of New Zealand Superannuation and the top-up scheme. It is highly unlikely that such arrangements would reflect the preferences of people on low to modest incomes, including beneficiaries, who have little discretionary income. Some people would retire on higher incomes than they earned when working and bearing the costs of raising a family. For these reasons, the initial suggestion that compulsory superannuation would be on top of New Zealand Superannuation provided on a universal basis is likely to be dropped; and

- most people previously provided for their retirement privately. The establishment of large-scale public pension arrangements is a development of the twentieth century. Public assistance was previously limited and most people provided for themselves by continuing to work until they were prevented from doing so by ill health, drawing on savings or property, or by relying on help from family, neighbours or charitable organisations. Untargeted public assistance was modest by current standards before National Superannuation came into effect in February 1977, and the capacity of most people to provide for themselves in retirement is much greater today than it was in earlier generations.

3.6 *Capital market failure.* It has been argued that capital markets limit private savings by failing to provide the scope for investors to hold a diversified range of assets. Secondly, unanticipated inflation can inhibit saving for retirement. Thirdly, insurance markets are said to be unable to provide appropriate cover against events such as an unanticipated shortening of one's working life.

These arguments are implausible because:

- financial institutions in New Zealand and elsewhere provide a vast range of products that enable small investors to diversify their risks. There has been substantial growth in such products in New Zealand over recent years, partly in response to the establishment of a more neutral environment for savings and competition within financial markets;
- some assets, such as property and inflation-indexed bonds, provide a hedge against inflation. Unanticipated inflation is, nevertheless, a concern. The best response lies in the retention of a sound monetary

policy directed at maintaining price stability and appropriate institutional arrangements for its implementation; and

- insurance markets provide cover for most people. While moral hazard and adverse selection problems lead to some constraints on the types of policies and coverage offered, the government is unlikely to be better placed to address them. Moral hazard is a significant problem that affects the welfare system. While compulsory schemes can limit adverse selection problems, they do so by cross-subsidising people in different risk categories and limiting competition with the result that the economy operates less efficiently. They do not resolve moral hazard concerns. Contributors may, for example, be encouraged to invest in very risky investments if the government is committed to topping up their savings on retirement. Such a strategy would offer the prospect of high returns while the risk of a highly unfavourable outcome would be reduced at the expense of the taxpayer.

3.7 *People generally earn insufficient income during their working lives to provide for their retirement or, alternatively, people won't save for their retirement – the so-called free rider argument. These arguments cannot justify a compulsory scheme because:*

- such a scheme cannot increase total income, other factors being equal. It requires people to reduce current consumption or other savings to contribute. If the scheme is actuarially fair, the annuity (or pension) must reflect the contributor's savings and the net income of the scheme (that is, compensation for forgone consumption net of administration costs). Higher pensions can only be provided to retirees if they are subsidised by future claimants on the scheme (an example of a chain IOU) or by current workers, for example by way of a subsidy out of current taxation. Both involve inter-generational transfers. The first is equivalent to borrowing to buy the groceries;
- it makes no sense to increase benefit levels to enable people who face a temporary drop in income to contribute to a superannuation scheme. Such people may recover from their misfortune. For example, there is limited unemployment among over 25-year olds. The groups most likely to be unable to save for their retirement are people who suffer from enduring health problems or permanent disabilities, full-time care givers, the long-term unemployed and people who otherwise have a patchy work record. Many of these groups may be supported in other ways, such as by family members or insurance. A compulsory savings scheme will not solve the problem of these people not providing for their retirement income and becoming dependent on the state. The government has indicated that the savings of between one-half and two-thirds of contributors will need to be topped up from taxes. The community will still expect the government to provide a safety net for people who cannot support themselves and who are not supported in other ways. This can best be done through income support during their retirement when their circumstances can be assessed with greater certainty;
- it is rational not to save voluntarily for retirement if the government provides a level of income that is judged by working age people to be adequate. The problem here is an excessive level of state provision rather than irrational behaviour; and

- the vast majority of people act prudently. The need for income in retirement is widely discussed within the community. This explains why it is an important political issue. There are no grounds to compel people to save if the numbers that are likely to be improvident are small. There is little reason for believing that they would be large, provided that the state safety net is set at a basic level.

#### 4 Other Criticisms of Compulsory Superannuation

4.1 A number of other reasons can be advanced for opposing compulsory superannuation. They include the following:

- compulsory superannuation involves a substantial intrusion of the state into the lives of individuals. Personal choices are constrained for doubtful reasons. It is hard to think of an intervention which would have a greater impact on the ways in which individuals are able to arrange their lifetime affairs. The grounds for government intervention in retirement income provision, other than by way of a basic safety net and, possibly, the provision of information, are substantially weaker than for health or disaster insurance;
- it is illogical to raise superannuation benefits and taxes, via enhancements to New Zealand Superannuation and the introduction of a compulsory superannuation scheme, to adjust for an aging population. A far better approach would be to reduce the generosity of New Zealand Superannuation relative to average weekly earnings for future cohorts of retirees and to target it more closely on the elderly who would otherwise face hardship;
- the Coalition government's proposals on superannuation and a compulsory superannuation scheme would impede adjustment for an aging population. Government expenditure would be increased by abolishing the surcharge and by funding contributions to the compulsory scheme for certain non-earners. The tax-funded income of current and future retirees would be increased, thereby encouraging dependence on the state. These steps would discourage voluntary savings. They contradict the view promulgated by recent National and Labour governments that most people should be expected to make provision for their own retirement;
- increasing the income of retirees is not a high social priority. Few of the elderly are among the poorest New Zealanders. Bob Stephens of Victoria University found that none were living in poverty in 1990/91 when the poverty line was set at 50 percent of mean income. Over 60 percent of the elderly were found to spend less than their income. Households with children on low market incomes and beneficiaries with dependent children should be accorded a higher priority because they face relatively greater hardship. At a time when their opportunities are highly constrained, they would be taxed to fund higher superannuation payments for present retirees, because the surcharge is to be abolished, and to provide for their own future retirement. These outcomes are regressive and inequitable;
- a compulsory superannuation scheme would do nothing to reduce the numbers of people in a range of categories from being dependent on the state for support in their later years, and would do nothing to help them. They include the following:

- people who are born with severe mental or physical disabilities,
  - widows with dependent children and with few assets,
  - people who suffer major injuries or illnesses before reaching retirement and who are not supported through private insurance or the Accident Rehabilitation and Compensation Insurance Corporation,
  - full-time care givers who are unsupported by their former spouses or partners,
  - recent refugees who have had little opportunity to re-establish their lives,
  - middle and older age immigrants with limited assets,
  - people who, for a variety of other reasons, have little attachment to the workforce and a poor work ethic,
  - other people who earn very low market income during their lives, such as people with few skills, voluntary workers and certain members of religious communities,
  - people who have spent much of their lives in prison;
- New Zealand Superannuation could be regarded as a government-provided compulsory scheme that is funded from taxation on a PAYG (pay-as-you-go) basis and is actuarially unfair. Some elements of the proposed scheme are also likely to be actuarially unfair. Examples include provisions relating to single and married (or equivalent) annuitants and the gender of contributors. There are no efficiency grounds for departing from an actuarially fair scheme on grounds of marital status, gender, race or other factors. The international record is that not one government insurance/savings scheme has remained actuarially fair for long;
  - a compulsory superannuation scheme would bias contributors' preferences. Consumption and savings are unlikely to represent a constant proportion of each person's income. They can be expected to fluctuate depending on circumstances. People on low to moderate incomes will face substantial difficulty in saving to buy a house and service an unsubsidised mortgage if 8 percent of their gross income is committed to compulsory superannuation. The inability of contributors to draw on personal savings should an adverse event occur during their working lives, such as serious illness, accident or marriage break-up, would reduce their welfare and expose the government to additional fiscal risks. What will happen when a person appears on television to plead for access to superannuation savings or government assistance to help fund a life-saving operation that is only available overseas for his or her young child?;
  - the scheme would reduce incentives to work, save and invest, and would adversely affect a host of other choices. It is equivalent to a tax increase for all citizens who would not otherwise save at the prescribed level. A contribution level of 8 percent on top of the present tax scale could increase the marginal tax rate for a person with

an annual income between \$9,500 and \$34,200 from 21.5 percent to 29.5 percent, an increase of 37 percent. *It would constitute one of the largest increases in income tax ever imposed in New Zealand, if not the largest.* While it might be argued that the rate of tax is lower than that applied in the past, such an argument is not valid because the tax base is now much broader than previously. Very high effective marginal tax rates may apply where government assistance, such as family and income support and the accommodation supplement, is abated or where student loans are being repaid. A compulsory superannuation scheme could be expected to impose substantial deadweight costs on the community and reduce the growth potential of the economy.

The government has said that it will cut taxes to offset the compulsory superannuation contribution. This will not, however, be feasible unless the government reduces its spending by, perhaps, as much as \$4–5 billion (up to 15 percent) and/or accepts a substantially lower operating surplus and higher debt than otherwise. There is a further problem. It is not possible to change the tax scale so that every contributor gets a tax cut equal to his or her contributions. Individual circumstances differ significantly and retirees will not be required to contribute. One possible approach would be to provide tax rebates for compulsory savings but this would leave marginal incentives affected by the higher rates of income tax referred to above;

- there would be pressure on wages as people reduce their willingness to work in response to a higher effective tax. Increased wages unmatched by productivity gains would lead to higher unemployment, especially among those with little attachment to the workforce such as those with few skills or without a strong work ethic;
- the implementation of a compulsory superannuation scheme would require significant regulation that would impair the efficiency of capital markets:
  - registered institutions would be favoured. Competition would be reduced thereby impeding innovation and raising costs. Registered providers would benefit from an implicit government guarantee that would reduce their incentive to be efficient and expose the government to fiscal risk if they failed. The DFC case demonstrates how difficult it is for the government to adopt a hands-off stance when government backing is assumed. Prudential supervision of registered banks illustrates the problem of implicit government guarantees that arises when the government registers firms. Similar problems would arise if individuals are forced to save with institutions that are authorised by the government,
  - the form of the scheme's investments would need to be constrained. Otherwise contributors could borrow back their savings and defeat the purpose of the scheme. In practice it would be difficult to prevent people from undermining the intent of the scheme in this way. The retail sector's willingness to anticipate the 1996 tax cuts illustrates this point. This difficulty would increase the more liberal are the rules for investments and qualifying schemes;



- government schemes are open to interference on political grounds. Contributors usually have few opportunities to enforce their rights. With a lawful contract changes can only be made by mutual agreement between the parties. Equivalent property rights are not normally conferred on contributors to government schemes. The government usually reserves the right to modify contributions and entitlements through the political process. The Accident Rehabilitation and Compensation Insurance Corporation scheme illustrates these points.

Australian experience also suggests that, over time, governments are likely to interfere with the decisions of superannuation funds for political reasons, with harmful consequences for the allocation of capital. The Keating government, for example, put pressure on institutions to invest in venture capital projects and in infrastructure, and to direct funds to Australian rather than offshore investments, regardless of the possibility of lower returns and higher risk. A government led by a politician with interventionist tendencies such as those of the late Sir Robert Muldoon could be expected to act in similar ways. Any legislative safeguards that are put in place could be repealed;

- government schemes encourage litigation. The courts could be expected to add to the costs of the scheme by broadening entitlements to distressed litigants and payable by a faceless government with an apparently unlimited funding capacity. Court decisions have contributed to the creeping cost of ACC;
- the suggestion that the government will top up the scheme on behalf of certain non-earners involves a large potential cost. About 30 percent of the civilian, non-institutionalised population aged 15 to 64 is not engaged in full- or part-time employment. Like the domestic purposes benefit, the scheme would further undermine the family and the acceptance of personal responsibility. Any proposal to provide assistance to care givers should be examined carefully on its merits;
- there would be a large incentive to avoid compulsory contributions just as there is to avoid the surcharge. Incomes earned through trusts and companies, and as fringe benefits rather than as wages, are obvious examples;
- substantial administration and compliance costs would be imposed on the community. Changes to existing private superannuation arrangements may need to be negotiated with contributors before they can be brought within the top-up arrangement. Government schemes often involve continual fine tuning in addition to major changes from time to time. Australia has made over 2,000 changes to its superannuation arrangements since the early 1980s. Enforcing compliance has been a longstanding problem with Chile's scheme. Forty-five percent of contributors to the Chilean scheme are reported to be in default of their obligations. Twenty percent are more than a year behind;
- the government's tax simplification programme has significantly reduced the number of people required to file tax returns. The introduction of a compulsory savings scheme, which would require contributions to be assessed and monitored and entitlements to be

recorded, would require this aspect of the simplification exercise to be unwound;

- the possible establishment of a public scheme, as an investment option, would lead to the well known problems of performance associated with government ownership of businesses, including financial institutions. Poor incentives would lead to inefficiencies, for example mispricing which would drive out competitors. Lobbying by government enterprises leads to regulatory provisions that favour them. Such inefficiencies may not be apparent for some years because an evaluation of the viability of long-term insurance arrangements is difficult as it is affected by many assumptions about future earnings and mortality rates. The Accident Rehabilitation and Compensation Insurance Corporation provides an example of the type of problems that would emerge over time. The union that covers the relevant part of the Chilean financial services sector agrees that the Chilean superannuation scheme employs four times more sales staff than are required;
- the introduction of a compulsory superannuation scheme would lead to new uncertainty for savers, firms and financial institutions. Substantial changes were made with the move to a more neutral tax environment for private savings, and the benefits are beginning to be seen. Policy uncertainty would undermine the progress which has been made in encouraging people to save on a voluntary basis; and
- the design of a feasible compulsory superannuation scheme would pose many problems. They would include the following:
  - the specification of who is required to contribute to compulsory superannuation. Difficult issues would arise in respect of people who are due to retire shortly and who could expect a negligible annuity if they are required to contribute, short-term visitors (such as staff on secondment from overseas) and New Zealand residents temporarily working abroad. Would people whose compulsory savings are likely to generate little income relative to the scheme's administration costs, perhaps because they only occasionally undertake paid work, be exempt?
  - the establishment of rules relating to withdrawal from the scheme. At what point would the obligations to contribute cease in respect of residents who emigrate? Would they be able to withdraw their savings with income accrued? Would annuities be paid to retirees who emigrate or people who are overseas on a temporary basis (c.f. the incident concerning entitlements to income support for competitors at the paralympics). Would people of working age who are suffering from a terminal illness be permitted to withdraw their savings?
  - the definition of income that is subject to the compulsory levy. If income were to be defined as wages and salaries and benefit income (that is, a payroll approach similar to the Accident Rehabilitation and Compensation Insurance Corporation), there would be incentives to convert income into other forms (such as bonuses, fringe benefits, interest and dividends). This problem is reduced with the Accident Rehabilitation and Compensation Insurance Corporation because income subject to the levy is capped. There would also be incentives to trap income in

companies and trusts. The self-employed would have greater scope to do this than salary and wage earners. If a broad definition of income were adopted, income from businesses and profits may need to be defined. Would income earned offshore be liable? The definitions of income used for tax purposes are subject to ongoing litigation,

- the determination of restrictions on the amount of annuities, if any. There have been initial suggestions that partners would be preferred relative to single people in the event of death during retirement. This raises controversial issues relating to the definition of a partner. Would, for example, gay and lesbian partners be treated on the same basis as married people? More broadly, the application of the principles underlying the Human Rights Act 1993 would need to be addressed.

If annuities are not computed on an actuarially fair basis, adverse selection problems would begin to loom large. They arise where the scheme is attractive to a particular class of contributors. For example, if the rules favoured married people relative to single people and if contribution rates were fixed, a scheme provider would have incentives to discourage excessive enrolment by married couples or people who are likely to marry. A provider might seek to do this through its advertising and the location of its business.

Government announcements indicate that on retirement a contributor's accumulated savings will be required to be used to buy an annuity for life. Some people believe that lump sum withdrawals should be permitted. There will also be pressure to allow surviving spouses and children to benefit in the event of the early death of contributors.

Financial institutions would be unable to offer fully inflation-proofed annuities unless the government issues inflation-indexed bonds (or equivalent investments) in vast quantities. This is unlikely to be an efficient way to finance government assets. Thus retirees are likely to face greater inflation risks and lower returns because of the uncertainty involved in pricing annuities than if their accumulated savings were invested in other ways,

- the establishment of the contributors' rights, if any, to pledge their accumulated savings as security for loans or to assign or transfer their annuities. Would contributions or annuities be available to unsecured creditors in the event of bankruptcy? Would contributions be confiscated by the Crown where illegal activity such as dealing in drugs is involved? In the event of the insolvency of an employer, what status would be accorded contributions that have been deducted from tax or are due but have not been paid to the fund?,
- the criteria for registering and deregistering providers. Would the government be prepared to register any scheme provider? If not, what prudential and other requirements would be proposed? Could overseas providers be registered? If not, competition would be reduced and the average risk status of providers would be increased. The administration of

registration arrangements would require the establishment of a new government agency or unit,

- the rules, if any, relating to changes in providers. Would contributors be able to change providers at will? Would existing savings be transferred or would only new savings be affected? Each year about 20 percent of contributors to Chile's scheme change providers despite rules aimed at achieving a narrow dispersion of earnings among schemes,
- would providers be free to set fees? If not, what controls would be placed on them?

## 5 Conclusions

### 5.1 Compulsory superannuation is undesirable for the following reasons:

- a key feature of retirement income policy should be the promotion of economic growth which alone can deliver the real goods and services needed by a growing number of elderly. Interventionist policies reduce economic growth;
- the provision of income in retirement should be a private responsibility for the vast majority of New Zealanders, as in many other countries;
- the government should provide a safety net. Policy on New Zealand Superannuation has been heading in the right direction (gradual increases in the age of eligibility, reductions in the generosity of support and, until recently, a commitment to targeting);
- there is no evidence that the voluntary approach is not working. To the contrary, there are encouraging signs that New Zealanders are becoming more conscious of the need to plan for their own retirement and are acting accordingly. The Accord framework can be used to build on these developments and maintain a stable political consensus. Another change to policy would be highly disruptive to many individuals, taxpayers and institutions;
- an increase in untargeted support for the elderly is a step in the wrong direction;
- compulsory superannuation involves an unjustified intrusion into people's lives. The welfare of savers would be reduced;
- concerns about savings deficits and risks to national sovereignty from foreign investment are misplaced. They do not justify compulsory superannuation;
- with a compulsory savings scheme government assistance would still be required for people on low incomes and non-earners who are not supported in other ways, such as people with little attachment to the workforce and care givers, and for those whose savings were lost following the failure of a financial institution;
- compulsory superannuation is equivalent to a tax increase for all citizens who would not otherwise save at the prescribed level. A

large rise in the effective rate of tax would be imposed on many citizens. A government that is committed to increasing its spending cannot cut taxes to offset superannuation contributions and maintain a prudent fiscal policy. Incentives to work, save and invest and a host of other choices would be adversely affected; and

- the introduction of a compulsory scheme would be a massive and vastly expensive undertaking. Substantial resources would be committed to the design and operation of the scheme. Ongoing regulation and litigation can confidently be expected. Its implementation would require detailed attention by the government and involve ongoing political controversy as changing circumstances forced amendments to it over time.

## Retirement revolution

Many countries are banking on private pension plans to raise savings rates and spur economic growth. Does Chile's reform show the way?

SANTIAGO, the capital of Chile, may seem an unlikely place of pilgrimage, but for economists it has become something of a Mecca. Fifteen years ago, Chile privatised its pension system. Many argue that this pioneering reform underpinned the country's subsequent economic success, especially the spectacular rise in its national savings rate, from 8.2% of GDP in 1981 to 27.6% in 1995.

Small wonder, then, that other Latin American countries, including Argentina, Colombia and Peru, have already adopted watered-down versions of the Chilean reform. Several Eastern European countries are considering similar systems. Their hope is that privatising pensions will lead to higher savings which will, in turn, boost investment and lead to faster growth. But is that really the lesson of Chile?

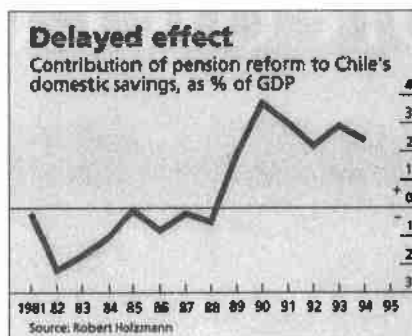
The purpose of Chile's reform was to replace a near-bankrupt public pension system with one based on individual retirement accounts. Workers were required to provide for their own retirement by putting at least 10% of their salaries into privately managed (but heavily regulated) pension funds. A worker's pension will depend on how much he pays into his fund and the returns the fund earns—not on what the government promises. This makes it a "defined contribution" system. Most public pension schemes, in contrast, are "defined benefit" systems, in which the state guarantees a particular pension regardless of how much a worker has paid in. In Chile the state guarantees only a minimum benefit as a safety-net.

In theory, the shift to a fully funded, private pension system yields several benefits (quite apart from preventing governments penalising future generations through their generosity to current ones). The first is that savings rates may rise if, for instance, the minimum contribution a worker must make to his pension fund is more than he would voluntarily save, or if the higher returns earned by these funds prompt him to save more. Second, the financial sector may benefit as competition between pension funds creates more efficient capital markets. And third, labour-market distortions may also be reduced: whereas a pay-as-you-go system encourages employers to hire "informal" or unregistered workers to avoid paying the payroll tax, a private system gives

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workers an incentive to work on the books so they can contribute to their own retirement accounts.

Each of these effects seems to be occurring in Chile. The national savings rate has almost quadrupled and is now easily the highest in Latin America. Today's stockmarket capitalisation is over 100% of GDP, up from 24% in 1986. Chile is the only country in the region with an active long-term corporate-bond market. Employment in legally registered jobs has in-



creased sharply.

But correlation does not prove causation. Many other reforms, such as trade liberalisation and privatisation, were also taking place in Chile. So how much was pension reform responsible for the transformation?

#### Right means, wrong reasons

The answer, suggests Robert Holzmann, an economist at the University of the Saarland, in Germany, is that the pension reform deserves only part of the credit. In a recent paper\*, he notes that private pensions have been good for Chile—but not for the reasons many of their more avid enthusiasts claim.

The growth of pension funds has been extraordinarily positive for Chile's financial markets. The stockmarket index, for instance, began a sharp rise in 1985, the first year that pension funds were allowed to invest in equities. Trading in stocks and bonds has grown in line with pension-fund assets, suggesting that the funds are a big source of market liquidity,

\* "Pension Reform, Financial Market Development, and Economic Growth: Preliminary Evidence from Chile." IMF Working Paper WP/96/94. August 1996

even if they account for only a small proportion of total shareholdings.

The reform's impact on savings, however, has been mixed. Mr Holzmann calculated how much private saving the new funds directly generated by adding up the flow of money into pension funds and the returns they reaped. Then he subtracted the direct loss of savings due to reform. This includes the public spending involved in providing pensions to people who retired under the old system, as the government no longer receives new contributions from current workers to pay pensioners. It also includes the cost of compensating workers who switched to private funds for the payments they had previously made into the old system. Subtract these lost savings from the new savings directly generated by the pension funds, and the overall direct impact of pension funds on saving was actually negative between 1981 and 1988 (see chart). Surprisingly, Chile's national savings rate rose in that time despite, rather than because of, the new pension scheme. Only after pension reform had been in effect for eight years did it cause the savings rate to rise.

But looking at the direct effect alone is misleading, Mr Holzmann says. The reform had two big indirect—and positive—effects on saving. The first was through fiscal policy. Chile financed most of the transition costs to a new retirement system by cutting expenditure elsewhere. This raised the savings rate directly because the public sector's surplus or deficit is a big part of national saving.

The other indirect link was via the boost private pensions gave to financial and labour markets. Deeper, more liquid capital markets, for instance, almost certainly helped boost Chile's growth by increasing the efficiency with which savings were used. And higher growth, in turn, can itself lead to higher savings. Chile's savings rate started to rise in the mid-1980s, just as its growth rate took off.

So, three cheers for pension reform? Wait, Mr Holzmann says. While it was straightening out Chile's pension mess, the government was also busy tightening its budget belt. This increase in government saving, Mr Holzmann argues, underlies much of Chile's economic advance. That is important for countries seeking to replicate Chile's success. Chilean-style pension reform is an excellent idea, but the switch to private pension funds alone will not boost savings quickly. That requires sound fiscal policy.

**CHRISTCHURCH BUSINESSMEN'S CLUB**

**WHAT'S ALL THIS ABOUT  
INDIVIDUALISM?**

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

**CHRISTCHURCH  
21 APRIL 1997**

## WHAT'S ALL THIS ABOUT INDIVIDUALISM?

Speaking at the Anglican Care conference in Christchurch just over two years ago, Alliance leader Jim Anderton was reported as saying that the Treasury viewed New Zealanders "merely as individuals who happened to live in the same area." He went on to tell us that this view:

... had led to the imposition of alien values based on a commercial model and produced selfish, competitive individualism instead of mutual support and cooperation.

This theme is also a popular one in the churches, and not only in New Zealand. Melbourne's Archbishop Keith Rayner, Primate of the Australian Anglican Church, recently claimed that the ideals expressed in the Bible:

... postulate community, not rampant individualism and competition; bearing one another's burden, not knocking your neighbour down ... [nor] regarding people as productive units or cogs in a machine.

Similar rhetoric can be encountered almost every day – rhetoric that associates individualism with selfishness, and community with altruism. Yet these associations are wholly misconceived. Individualism and community are not opposites or mutually inconsistent. We are not forced to choose one at the expense of the other. As Alexis de Tocqueville observed, in democracies "all become powerless if they do not learn to help one another voluntarily". Moreover, a society in which individuals have a high degree of economic freedom actually strengthens social cohesion and gives a freer rein to altruism.

However, despite the demonstrated success of the open economy and society, attacks on economic and social freedom will continue. As the scientist Terence Kealey has recently put it:

The historical (and contemporary) evidence is compelling: the freer the markets and the lower the taxes, the richer the country grows. But *laissez faire* fails to satisfy certain human needs. It fails the politician, who craves for power; it fails the socialist, who craves to impose equality on others; [and] it fails the businessman, who craves for security ... . It also fails the idle [and] the greedy ... who crave for a political system that allows them to acquire others' wealth under the due process of law. This dreadful collection of inadequates, therefore, will coalesce on *dirigisme*, high taxes and a strong state. They will seek to organise society politically, not economically.

Thus the first point to make is that the individualism/community distinction is unhelpful. Rather, individualism is to be contrasted with collectivism, and it is attacked by those who espouse collectivism in its various guises – from the early socialists 150 years ago to the so-called communitarian movement today. For much of the 20th century, communists and social democrats (and even some who called themselves conservatives) shared the belief that socialism was the wave of the future. They thought capitalist competition was fatally undermined by inefficiencies and unacceptable inequities, and would eventually succumb to the demand for a just, rational, planned economic order. While that view was never soundly based in experience, over the last 20 years it has been decisively refuted by events. Not only did full-blown communism prove unsustainable, but the promise of 'social democracy' in western countries went sour with the combination of slow growth, high inflation and rising unemployment.



By contrast, increasing economic freedom has produced spectacular growth in many developing countries in Asia, Latin America and now even Eastern Europe, and the 21st century could usher in the widest spread of market-based prosperity that the world has ever seen. Yet at least in western countries like New Zealand, this success has still not put beyond question the legitimacy of the free enterprise system among intellectuals and commentators. Many are still captivated by the socialist dream, even though in practice it repeatedly turned out to be a nightmare. They lament that we seem to be stuck with a system which they regard as morally inferior to socialism, and which can at best merely be tamed and modified by government intervention. If capitalism is to be allowed a material victory among such people, it is certainly to be denied a moral one: the profit motive remains as disreputable in their eyes as ever. We will no doubt continue to hear complaints about 'the law of the jungle', 'the pursuit of profit', 'cogs in machines' and 'atomised individualism' from academics, clergy and other commentators.

But stubbornly, much human behaviour will remain as 'individualistic' as ever. It is ironic that those who denounce individualism and espouse collectivism nevertheless behave in their own economic lives just like individuals who support markets. They sell their houses to the highest bidders, snap up bargains when the opportunity arises and, I dare say, lawfully minimise their tax liabilities. Being known to oppose capitalism may be a fairly reliable indicator of the way some people vote, or whether they work in the state or private sector, but it is no indicator of their personal behaviour.

Moreover, the idea that collective action embodies altruism and sacrifice, and that individualism embodies selfishness and greed, is a fantasy. 'Collectivism' and 'individualism' are different social systems. Collectivism was defined eighty years ago by the English jurist Albert Dicey as:

... government for the good of the people by experts or officials who know or think they know what is good for the people better than any non-official person or than the mass of the people themselves.

Under collectivism, the major decisions about the economy and society are taken by central institutions, normally the state. In a market economy, which allows individual freedom, those decisions are largely left to individuals to make for themselves. Every society contains some mixture of collectivism and individualism. No modern society is without a state, just as none lacks at least a small sphere of individual initiative, expressed in markets and other kinds of voluntary action.

It is extraordinary that so many in the church have been seduced by collectivism in the last 30 years or so. Many seem to have fallen under the influence of people like the Harvard theologian Paul Tillich, who wrote that "any serious Christian must be a socialist". Yet no proposition could be more inconsistent with traditional Christian religion. As the Catholic writer Michael Novak has pointed out:

... it is no accident that a capitalist economy grew up first in the part of the world deeply influenced by Judaism and Christianity. ... Capitalism is not about individualism. It is about a creative form of community.

At a deeper level, Christianity is also about the relation of the individual to God, and to other human beings. Collectivist regimes like the Soviet Union did their utmost to suppress such relationships. Their counterparts today are the oppressive regimes of Iran, Iraq, Libya, Myanmar, Cuba and the like. These are the societies in which people are indeed treated as 'productive units' or 'cogs in a machine', and less authoritarian collectivist regimes are just variations on this theme. Church leaders like the Melbourne archbishop have comprehensively lost the plot.

Over the last 20 years economic policy changes in almost every corner of the world have seen a major expansion of the individual sphere at the expense of the collective. This counter-revolution has brought large benefits, but they are not confined to economic efficiency as narrowly understood. More fundamental moral considerations are also at stake. Market liberals welcome the expansion of the individual sphere as enhancing freedom and the scope for moral behaviour; collectivists regret the greater scope they think this has given to the forces of selfishness, at the expense of community.

Are the collectivists right? Does an expansion of economic freedom bring with it, as they argue, an abandonment of 'compassion' and 'solidarity' in favour of a 'dog-eat-dog' society? Is this a price we may have to pay if we want to preserve or increase our living standards? I think not; indeed I will argue that the consequences are quite the reverse.

The claim that individualism is equated with selfishness and collectivism with altruism was very effectively debunked by Karl Popper, who wrote his famous book *The Open Society and its Enemies* in this very city while a refugee from collectivism during World War II. Popper pointed out that:

Collectivism is not opposed to egoism, nor is it identical with altruism or unselfishness. Collective or group egoism, for instance class egoism, is a very common thing ... and this shows clearly enough that collectivism as such is not opposed to selfishness. On the other hand, an anti-collectivist, i.e. an individualist, can, at the same time, be an altruist; he can be ready to make sacrifices in order to help other individuals.

Popper thought that the confusion arose very early in Western political thinking. He traced it as far back as classical Greece, where the philosopher Plato wrote that:

The part exists for the sake of the whole, but the whole does not exist for the sake of the part ... . You are created for the sake of the whole and not the whole for the sake of you.

Plato's view seems fundamentally illogical: a society, in the end, is composed of individuals. Popper interpreted Plato's misconception as a throwback to a prehistoric tribal morality that emerged at a time when survival did require individuals to subordinate their private interests to those of the group. He went on to explain modern collectivism – with some plausibility – as an attempt to recreate tribal morality. Some people long for a certainty and order that they feel is missing in today's world. At bottom it is a longing to avoid the burden of civilisation. But the benefits of civilisation are possible only if individuals accept a large degree of individual responsibility for their own lives.

For Popper, 'class egoism' is evidence that collectivism does not equate with altruism. But a more striking example is nationalism. Though widely condemned today, nationalism is the most popular form that collectivism has ever taken, and the one that has inspired, for better or worse, immense individual sacrifice.

There is a tendency to regard nationalism, and its extreme manifestations in fascism and Nazism, as polar opposites to communism – on the right rather than the left of the political spectrum. Yet the Nazis called themselves national socialists for good reason. Anti-individualist sentiments predominated in Germany in the years after World War I. Nazis, communists and social democrats were locked in a ferocious struggle over which of them would inherit the collectivist mantle. Hitler understood this: the Nazi flag was red, in brazen imitation of the communist flag, though with a swastika on it. After the Nazis came to power in 1933, thousands of ex-communists flocked to join the party. Hitler even arranged special positions for them, since they had been usefully trained in totalitarian techniques.

Our revulsion at the Nazi period of German history has often led us to forget that German collectivism in the late 19th and early 20th centuries had great international popularity and influence. The forms of social insurance that New Zealand and Australia adopted at the turn of the 20th century, and Britain a few years later, were inspired by measures introduced in the 1880s by the German chancellor Bismarck. The only other place where their industrial relations systems were adopted was the Weimar Republic. The Nazis continued this tradition. In 1920, they adopted a programme calling for major extensions of the welfare state, summarised in the slogan "The common good before the individual good." They stood for what they called a *Volksgemeinschaft*, a 'people's community'.

Most people would concede that collectivism is not automatically good, and that some of its manifestations like the Nazi regime led to monstrous evil. But surely, they would argue, the collectivism of the modern, social democratic state, where governments are subject to electoral dismissal, is a different matter? Does not the modern welfare state embody our collective altruistic determination to aid the sick, the disabled and the needy? To a degree it does: most of us would agree that there is a case for financing a social safety net out of taxation. But other motives are also at play.

After all, most welfare state spending goes to people who do not strictly need it. Much goes straight back to people who paid the taxes to finance it in the first place. Huge sums of money are now politically at stake as resources flow to various interest groups. The battles that are fought out as each interest group tries to grab a larger slice of the cake, while shifting the costs on to other groups, are the reverse of what we should call altruism. If collectivism is so unselfish, why are superannuitants, nurses, teachers and other such groups not offering to take cuts in income? The truth is that the gathering fiscal crisis of the welfare state in most western countries cannot be blamed on excessive spending on the disadvantaged. Rather, it reflects the never-ending pressure for more spending on services like education, health care and age pensions – all stoutly defended by the champions of their beneficiaries as they jostle and compete with one another for the spoils.

The lesson to be drawn is that collectivism is fundamentally just one way of doing things. Collective action by the state is needed to ensure the provision of a sound legal system, genuine public goods and a social safety net. Thus for the foreseeable future services such as defence, law and order and some infrastructure will continue to be delivered and paid for collectively. Collectivism can be driven by any of a wide range of motives, worthy or otherwise. As a mechanism, its relative efficiency is open to objective investigation. By and large, it performs worse than methods that rely on individual initiative. This is the basis of the economic case for limited government.

It is not too difficult, then, to debunk the claim that collectivism equates with altruism. It is also easy to deal with the claim that individualism equates with selfishness. There is often confusion on this point. One source of confusion is the frequently misquoted statement of Margaret Thatcher that "there's no such thing as society". This remark has been widely interpreted as a defence of selfishness. Lady Thatcher was in fact saying the opposite, and her complete statement is instructive:

I think we've been through a period where too many people have been given to understand that if they have a problem, it's the government's job to cope with it. 'I have a problem, I'll get a grant'. 'I'm homeless, the government must house me.' They're casting their problems on society. And you know, there's no such thing as society. There are individual men and women, there are families. And no government can do anything except through people, and people must look after themselves first. It's our duty to look after ourselves and then, also, to look after our neighbours. People have got their entitlements

too much in mind, without the obligations. There is no such thing as entitlement, unless someone has first met an obligation.

To interpret this passage as condoning selfishness takes an effort of distortion that is quite impressive in its own way. Far from praising selfishness, Lady Thatcher was delivering a homily about the importance of consideration for others and denouncing people who try to shuffle their personal responsibilities to help others on to the state. Her message was very clear. Not only do individuals exist, but families and neighbours exist as well. People have obligations to look after their neighbours as well as their families. The goods and services that the state delivers collectively first have to be produced by individual effort. Unless people make some efforts of their own, there is little the state can do to help. All this seems eminently sensible. Moreover, as prime minister, Margaret Thatcher frequently affirmed there are positive roles that governments must play. And plainly there is 'society' in the sense of a cultural heritage or a national tradition which is a part of us all.

It is true that the language of individualism can often sound less morally uplifting than the language of collectivism. Collectivism speaks of cooperation, which can be taken to imply self-sacrifice in favour of the collective, although it seldom works out that way in practice – those in the party hierarchies have proven to be adept at exploiting the system. In contrast, the language of individualism incorporates the idea of 'self-interest'. 'Self-interest' is linguistically related to the word 'selfish', which has led to the two terms often being confused. In fact, self-interest and selfishness are two entirely different things. 'Self-interest' simply refers to individuals pursuing goals that they choose for themselves, rather than goals selected collectively. But these goals may be entirely unselfish, like the promotion of good causes. Just as collectivist methods may be put to evil purposes as well as good ones, so individuals can choose altruistic as well as selfish goals. The typical goal, I suggest, is not one's own welfare narrowly understood, but includes the welfare of one's immediate friends and family, with self-interest and family interest being particularly closely identified.

Markets have a moral advantage over collectivist systems, since market activity is based around the idea of voluntary cooperation in a way that political activity is not. In any market transaction, two or more parties choose to conduct an exchange in which all sides expect to be better off. We cooperate voluntarily with others when we buy a newspaper or a motor vehicle, enter into an employment contract, buy or rent a house, put money on deposit or take out a loan. A market economy is a vast network of voluntary cooperation among peoples, for mutual gain. By contrast, collective political action usually involves winners and losers, with the winners effectively coercing the losers.

Provided market exchanges are free of coercion or fraud, the pursuit of self-interest through markets also benefits others. Far from being selfish, self-interest in a market economy drives the entire system. It is in our interest to cooperate with others, and so we do. The most everyday and apparently simple product – a pencil, say – is designed, produced, transported and sold as a result of countless individual acts of cooperation amongst numerous people, most of whom have never met each other, all following their own self-interest. As Novak puts it, business is a community activity: "the modern business system expresses the interdependence of the whole human race." All this was fully understood by Adam Smith: he saw that economic freedom linked humanity in a great division of labour, kept together by an 'invisible hand' which usually led those following their own self-interest to indirectly serve the wider good.

The metaphor of the invisible hand is easily parodied into meaning that in a market economy we can act as selfishly as we like, since the market ensures that no harm is done. But in fact Smith argued the opposite. Smith was a moral philosopher who believed that a market economy worked best when underpinned by a strong culture of

civic virtues. He is sometimes accused of ignoring altruism – but only by people who have never read even the first sentence of his book, *The Theory of Moral Sentiments*. It begins:

How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it but the pleasure of seeing it.

Smith believed every man or woman had the capacity to sympathetically visualise other people's circumstances by putting themselves in their position. He saw every person's conscience as an 'impartial spectator' who judged his or her actions in terms of broader moral standards. He affirmed the virtues of prudence, beneficence and justice, and considered that society was possible only to the extent that these virtues were observed. All this is a world away from the crude caricature of Smith's thinking as 'atomised individualism' so often dredged up by opponents of markets.

Why does it seem so hard to get that point across? Partly, perhaps, because of a lack of imagination when it comes to markets. When we think of markets we might think of the stock exchange – an impersonal and largely faceless trading system. But we could just as well think of the fruit and vegetable markets of our cities, or the bazaars of Asia or the Middle East. These markets are surely driven by self-interest, but the prevailing atmosphere is one of harmony and cooperation, even – dare I say it – community.

Market exchanges are not normally characterised by deceit and distrust, but by mutual goodwill and cooperation. When we hand over 70 cents to a newspaper boy, we expect he will give us a newspaper. If he gives us the newspaper first, he expects we will hand over the money. Of course, we can be conned and betrayed, but such behaviour is not only morally wrong but doesn't usually pay. Thus as individual participants in a market economy, critics and supporters of markets alike are generally willing to extend to others the trust necessary for commerce to get going. This trust makes exchanges easier – just try to imagine the costs and inefficiencies in a world where buyers and sellers of newspapers could not trust each other – and it is a form of social capital which is largely self-sustaining. It is more easily eroded by the uncertainties generated by arbitrary government intervention than by the operation of the market.

But the deeper reason why markets are seen as selfish is that in modern times many have come to identify 'community' simply with the realm of politics. All human life outside politics is then seen as 'individualistic' in the sense of being asocial and solitary. Thus member of parliament Lianne Dalziel, for example, accuses the New Zealand Business Roundtable of talking only about personal and family responsibility, and never community responsibility. For the hard Left, community responsibility means political action and collectivism.

Yet this is completely wrong. The romantic idea of the community-state, in which politics governs every aspect of life, is a fatal conceit. By taking on excessive, intrusive powers, the collectivist state undermines or destroys local face-to-face associations. It replaces these horizontal links between 'individuals-in-community' with vertical links between the individual and the state. The results of this alienation are all too evident. The modern form of the collectivist state was born with the French Revolution and died with the collapse of the Soviet Union. It is not likely to be quickly resurrected.

The alternative to the collectivist state does not involve just a mass of isolated individuals; no society can be like that. British Labour Party leader Tony Blair has often made the point that a strong society should not be confused with a strong state. As he has put it:

The history of workers' cooperatives, the friendly societies and the unions from which the Labour Party sprang is one of individuals coming together for self-improvement and to improve people's potential through collective action. We need to recreate for the 21st century the civil society to which these movements gave birth ...

The possibility of a civil society in which people forge their own social networks, without these networks having to fit a pattern imposed from above, is a very real one. Most people in their private lives belong to community associations, whether temporary or permanent, formal or informal. That is what David Green meant by the phrase 'community without politics' in his book *From Welfare State to Civil Society*. The citizens of a modern, free and open society need not be united around a common goal or enterprise. Within a common set of rules and standards, they can pursue their diverse private goals, which usually include a concern for the welfare of their fellow citizens.

At present, New Zealand would surely benefit from greater reliance on community without politics. Issues of major public concern, such as rising rates of crime and welfare dependency, and poor standards in education, are not being satisfactorily addressed by a political system which has assumed responsibility for them. Faced with politicians who have let them down, people tend to withdraw into private apathy, or find individual solutions that may be less than satisfactory. But most of our problems are the result of public action being monopolised by the political system, with the consequence that there is reduced scope for solutions generated by individual cooperation - whether through markets or non-market activity. The resources available to deal with public issues are commandeered by the government through taxation, leaving citizens with reduced ability to assume responsibility for those issues themselves.

On this analysis, the way to revive our public life is to transfer more responsibility from government back to individuals in society. If central and local governments started giving people back their taxes and rates they could play a larger and more fulfilling role in a genuine community. People might then find other ways to educate their children, for example, and to assist the voluntary associations that they think do a good job of helping the disadvantaged to become self-supporting. This sounds, and is, quite a challenge: a moral challenge to all of us to get more involved in our communities. It asks us to concentrate more on our individual responsibilities and less on our rights to taxpayer resources. The era of big government is over, and political provision is no longer a credible response to our present social problems. Not for the first time, Jim Anderton got it exactly backwards: the inherent 'winner-takes-all' divisiveness of politics must yield to a civil society of voluntary cooperation and engagement if we want to find genuine solutions.

**THE ANNUAL CORPORATE MANAGERS DINNER**

**THE MULTINATIONAL COMPANY  
MASTER OR SERVANT?**

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

**AUCKLAND  
5 MARCH 1997**

of production into fewer and fewer hands and ultimately the replacement of competition and markets by monopoly. John K. Galbraith, for example in *The New Industrial State*, argued that supply and demand were reconciled, not by entrepreneurs and markets, but by a technical-managerial class, or the 'technostructure'. Management had seized control of giant corporations, marginalised the shareholders, and replaced the profit motive with an expansion motive. This it could do because it effectively controlled demand as well as supply. In the 1950s Galbraith had already argued in *The Affluent Society*, as had Vance Packard in *The Hidden Persuaders*, that commercial exchanges were not expressions of consumer sovereignty that guided entrepreneurs' productive decisions, but rather were expressions of the masses' enslavement by advertising, which generated the artificial wants that it suited the corporations to supply.

In the West, these beliefs encouraged corporatism, whereby governments sought to work with the 'technostructure' to ensure that the latter's interests coincided with the national interest. Galbraith's assertion that the management and the ownership of corporations had become separated had the effect of downplaying the distinction between the public and the private sectors, and sanctioned state ownership where it existed. In developing countries, Galbraith's analysis chimed well with the fashion of 'development economics', promoted internationally by organisations like the United Nations Conference on Trade and Development (UNCTAD), which encouraged governments to avoid multinational investment and instead to seek national self-sufficiency through import controls (to stimulate domestic industry) and commodity taxes (to fund investment).

The failure of 'think big' corporatism and of development economics scarcely needs to be rehearsed here. Giant corporations became notorious for sloth and rigidity, and were shown up by entrepreneurial firms that could respond quickly to changing consumer tastes. American corporations found themselves challenged by nimbler Japanese competitors. Developing countries, led by the Asian tigers, showed that low taxes along with openness to trade and foreign investment were a surer path to prosperity than self-sufficiency, which led only to stagnation and aid-dependency. They learned the wisdom of the aphorism of Professor Joan Robinson, the Cambridge University economist, that "if there's one thing worse than being exploited, it's not being exploited at all". Nowadays, multinational corporations thrive not on planning partnerships with governments but on market opportunities provided by an internationalised economy. Falling transport and communications costs, along with policy changes like the removal of barriers to foreign investment and the liberalisation of capital markets, have made it easier and less risky for companies to invest on a world scale, while the privatisation of state enterprises in many countries has provided additional opportunities for them to do so.

One recent convert to multinational investment is none other than Galbraith himself. In his latest book *The Good Society*, Galbraith tells us that the multinational corporation is not an agent of private imperialism but rather an almost benign source of inward investment and technology transfer. Reviewing this book, Robert Skidelsky remarked that:

It has been Galbraith's fate to survive into an age when practically all his assumptions, projections and remedies have been made obsolete by history with a capital H.<sup>2</sup>

We should at least be grateful that Galbraith has been prepared to adjust his ideas to reality.

<sup>2</sup> Robert Skidelsky, 'Whatever Happened to the New Industrial State?', *The Times Literary Supplement*, 11 October 1996.



Still, it is important not to exaggerate the scale and significance of multinational enterprises. In the early 1980s, some observers thought that internationalisation would enable multinational corporations to take over the world, by enabling them to realise huge economies of scale. In practice, internationalisation has released entrepreneurial forces that are subjecting large multinationals themselves to competition, as technology erodes economies of scale and makes possible more customised goods and services. In 1993 *The Economist* estimated that the number of multinationals had grown at least fivefold during the two decades to 1993, and that the top 100 multinational companies accounted for between 40 and 50 percent of all cross-border assets.<sup>3</sup> However, that represented only about 16 percent of the world's productive assets. And for all the talk of 'globalisation', almost every country funds the lion's share of its investment out of its own savings.

Similarly, there are very few multinational companies that are not deeply entrenched in their home countries: the idea of the pure multinational or non-national company floating in a kind of economic cyberspace remains something of a fantasy. So whereas Galbraith once believed that the free play of commercial forces favoured the concentration of economic power into ever fewer hands, experience suggests that the international economy accommodates a variety of processes – not just centralisation but decentralisation as well. If national sovereignty has appeared to become less effective, this reflects not so much the growing power of multinational companies as the increasing freedom of individuals, both as consumers and entrepreneurs.

### **The Benefits of Multinational Companies**

According to Statistics New Zealand, in the year to 31 March 1995 the level of foreign investment in New Zealand rose by NZ\$4.6 billion to \$96.7 billion. Nearly all of this increase consisted of foreign direct investment, typically by multinational companies – purchases of real estate, acquisitions of existing firms, and the creation of new businesses. Foreign direct investment rose to a level of \$40.3 billion in that year. The remaining investment consisted mainly of private portfolio investment (that is, equity participation in, and lending to, public and private enterprises).

New Zealand is a source of, as well as a host to, international investment, though on a much smaller scale. In the year to 31 March 1995, the stock of direct foreign investment originating in New Zealand rose by NZ\$1.8 billion to \$11.5 billion. Interestingly, given the debate over Asian investment, New Zealand has invested more in Asia over the last two years than Asians have invested in New Zealand. Yet New Zealand remains a net importer of capital by a wide margin, and about one-third of the workforce relies directly or indirectly for employment on firms that are at least partly foreign-owned. It is therefore vital that we understand, first, the very great actual and potential benefits that multinational companies can bestow on countries that attract their investments, and, second, how such countries can maximise and enjoy those benefits while remaining masters of their own fate.

Investment from multinational companies is *prima facie* beneficial in that it adds to a country's total stock of capital and so facilitates increases in economic activity, productivity and growth that otherwise may not occur. This is most obviously true when direct investment takes the form of new 'greenfield' enterprises. But it is true also when it involves the takeover of existing domestically owned enterprises or the purchase of real estate by foreigners ('selling off the farm'). One commentator has summarised these benefits thus:

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<sup>3</sup> 'Everybody's Favourite Monsters: A Survey of Multinationals', *The Economist*, 27 March 1993.

Economic benefits always accrue to the residents who choose to dispose of their assets to foreigners. ... Whenever domestic financial or real assets are purchased by non-residents, the amount of funds available to residents for additional spending is thereby supplemented. Moreover, when foreigners buy existing ... assets at higher prices than residents would be willing to pay, the ... sellers of those assets make capital gains that they otherwise would not have made. The proceeds of the sale of assets may then be used to create new domestic assets, to be spent on consumption, or even to acquire new foreign assets.<sup>4</sup>

There are two sides to every commercial transaction, and both sides benefit. If people sell off parts of the 'farm', it is because they see a net gain in doing so. Xenophobic restrictions on the level of foreign purchases of domestic assets impose costs in terms of forgone capital gains and, in the case of state assets, opportunities to further reduce public debt.

Another benefit that multinational companies can confer on their host countries is the promotion of trade. A large proportion of international trade occurs between multinational companies and between the different branches of such companies. This is especially true for trade in high technology products, which is growing fast and generates positive spillover effects. Commerce between multinational companies and domestic firms provides the latter with access to international trade networks and generally deepens a country's integration in the international economy, so helping it to discover and exploit more fully its comparative advantages.

A third benefit that multinational companies can bring is the strengthening of domestic competition. This is likely to be especially the case with small economies, many of whose markets may be dominated by one or a few suppliers. A striking example in New Zealand is the telecommunications market in which, before deregulation, Telecom Corporation enjoyed a virtual monopoly. Now several multinational telecommunications companies have entered the market. They are providing competition that would have been unlikely to emerge, at least in the short term, from New Zealand-owned companies because of a lack of financial muscle and technical expertise.

Of course, it is also possible for takeovers and mergers involving multinational companies to diminish domestic competition by reducing the number of producers in a market. However, in an open economy, mergers that reduce domestic competition may do little harm if the markets in which the companies operate remain exposed to international competition. This, in turn, depends crucially on the prevailing policy regime. If it is sound, the benefits that multinational companies can offer are unlikely to be offset by any harmful effects.

Multinational companies can also be sources of technological expertise. It is well established that technological progress is an important factor in economic growth. Multinational companies are a major transmission mechanism of such progress. Some technology is costly and requires substantial investment that only large companies, like multinational ones, can afford. As well, foreign direct investment is often the only way that multinational companies can fully exploit their investments in new technology, as they take advantage of, and bring together, various features of the global economy. The expertise that multinational companies transmit includes management techniques and work practices, which can be imitated by local firms and can help them to increase their productivity.

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<sup>4</sup> Tony Makin, 'Liberalising Australia's Foreign Investment Policy', *Agenda*, Volume 3, Number 2, 1996, p. 139.

Many of these benefits are evident in the activities of what is perhaps the world's best known multinational company: McDonald's. McDonald's is a leading symbol of what is often casually referred to as the 'Americanisation' of the world. But one of the most remarkable things about McDonald's is how deeply enmeshed it is in its host economies. Its burgers are produced from local ingredients: in Russia it actually owns and runs the agribusinesses that supply its wheat and beef. Its franchise system transfers its successful management techniques to local populations. Its famous system of employing and training local teenage labour creates lasting benefits for its employees. The competition it provides for local rivals has greatly improved the latter's quality of service. It is no wonder that countries are so eager to be invaded by McDonald's.

Indeed, the international success of McDonald's has made it possible to test the early nineteenth century theory of international peace through trade. The modern version of the theory, propounded by Thomas Friedman of the *New York Times*, maintains that no country with a McDonald's has ever gone to war with another. So far, it has passed all tests. Friedman is reported to fear a backlash from poorer nations unable to benefit from the globalisation of the world economy: "They may feel that their traditional culture will be steamrollered by it and fear that they won't eat the Big Mac, the Big Mac will eat them." But for the present, the news is good: "Relations between Andorra and Hong Kong, Sweden and El Salvador, and Iceland and New Zealand have never been better".<sup>5</sup>

### **Multinational Companies and Public Policy**

The appropriate policy stance towards multinational companies is one that removes unwarranted obstacles to foreign direct investment and creates an environment in which those investments are most likely to succeed. Of course, such policies (competitive tax rates; adequate infrastructure, education and training; transparent, simple and competition-enhancing regulations; flexible labour markets; and a stable macroeconomy) remove unwarranted obstacles to, and enhance the prospects for, domestic investment as well. Like domestic investors, foreign investors should not have to demonstrate that their proposals are in the public interest: rather, the burden of proof should lie with those who argue that they are not.

On the other hand, special treatment for multinational companies is likely to be inefficient and welfare-reducing. And it is under such policies that multinational companies can become our masters. Take the link between foreign investment and import tariffs. Some companies become multinational as a way of avoiding the trade-reducing effects of tariffs: unable to export their goods to countries with high tariff barriers, they shift their production to them instead. Some governments implicitly use tariffs as a way of attracting foreign investment. But, once inside the gates, multinational corporations acquire a special interest in the maintenance in perpetuity of protective barriers and can loudly threaten to liquidate their investments unless their favoured treatment continues. If their lobbying is successful, the economic distortions reduce potential national income and damage consumer interests.

Fortunately, multilateral trade organisations like the World Trade Organisation and APEC have drawn up common codes of practice that help countries resist attempts by protected multinational companies to play countries off against each other by seeking to maximise special favours. International competition for foreign investment tends nowadays to be indirect and benign, as governments limit tax rates and commercial regulation and concentrate on public investment in education and infrastructure.

<sup>5</sup> James Langton, 'The Golden Arches Theory of Conflict Resolution', *The Press*, 31 December 1996.

To summarise: if foreign investment is directly sought by concessions and favours, the patterns and levels of such investment could be inefficient and of little benefit to the receiving country. But where foreign investment is governed by a sound policy regime that applies in a neutral fashion across the whole economy, both foreign and domestic firms are disciplined by competition and resources tend to be used in ways that are of most value to the community.

### National Sovereignty

These arguments may not impress people, including some politicians, who prefer to conceive of economic sovereignty as a game played by nation states in which any economic gain that accrues to one nation must come at the expense of others. To this way of thinking, the profit that a multinational company repatriates to its shareholders is self-evidently a loss to the host country. However, profit repatriated from New Zealand to, say, the United States, Taiwan, or Australia represents a loss to New Zealand only if it is inflated by protection or subsidy, or by special deals that exempt the company from the tax laws and other regulations that apply to domestic companies. Otherwise, repatriated profit is evidence that the investment has succeeded in generating wealth, of which the host country has obtained a share. Would anyone seriously argue that the country would be better off if its foreign investors systematically made losses?

Economists emphasise the case for maximising the freedom of firms and individuals to promote their own welfare through voluntary decisions and exchanges. Barriers to international trade and investment are restraints on that freedom, and when exchanges are possible across international borders, everyone benefits. Economists see no contradiction in principle between such economic freedoms and national sovereignty: sound policies can enhance both, not one at the expense of the other.

The economic nationalist, on the other hand, views such economic freedoms as a threat to national sovereignty. What counts for such a person is the ability of the nation to implement political decisions about its preferred pattern of economic development. Individual economic sovereignty would be all too likely to disrupt such decisions, and so is likely to be suppressed in the name of national sovereignty. Economic nationalist regimes do not necessarily eschew foreign investment altogether. Although they are likely to try to avoid foreign involvement by funding more of their investment from national savings, they are typically willing to allow foreign investors in as long as they agree to conform with government determined national priorities. In such cases, however, multinational companies may be put off from investing altogether, or become the beneficiaries of privileges organised by politicians. The trouble is that countries that go down this road are likely to end up poorer and weaker, and therefore to enjoy less true national sovereignty, than those that give priority to individual sovereignty and economic freedom.

We in New Zealand have learned from bitter experience that politically determined national priorities are all too likely to lead to projects that, by ignoring or suppressing market forces, reduce national wealth and increase national debt. Such countries lose international prestige, goodwill, and – by becoming indebted to foreign interests – control over their own destinies. New Zealand in 1984 was at the mercy of the international financial system: if the financial reforms had not been adopted as a matter of policy by the incoming Labour government, the adjustments would have been imposed brutally by the financial markets or the International Monetary Fund (IMF). Today, New Zealand has regained the sovereignty it was at risk of losing. As an economy with one of the highest levels of economic freedom in the world, its attractiveness to overseas investors goes a long way to compensate for its small size and its vulnerability. It is an example of the way the free international market places nations on a truly equal footing by rendering irrelevant differences between them in terms of size and military might.

Globalisation of economic activity has done nothing to undermine national sovereignty – it has not reduced the power of individual countries to make their own decisions. New Zealand is just as free today to borrow extravagantly, debauch our currency or prop up uncompetitive industries as we were prior to 1984. The difference is that the consequences of adopting misguided policies impact on a country almost instantaneously. As Lawrence Summers, deputy secretary of the US Treasury, has put it:

One of the most foolish things said about the international economy these days is that because capital moves so quickly and so freely, government policies have little influence. In reality, precisely because of greatly increased capital mobility, the difference between having the right and the wrong government policies has never been greater. ... And just as good policies are rewarded more richly than before, mistaken policies are punished more severely.<sup>6</sup>

Thus the control of governments over the decisions of multinational companies is as powerful as it ever was. However, one thing is new: because the consequences of decisions on how these controls are used are more immediate and transparent, voters have much more control over governments. Why anyone would view this development as a threat to national sovereignty or democracy is difficult to understand.

### Concluding Comments

The role and impact of multinational corporations, and the degree to which they can dictate outcomes to their advantage, have evolved with the changes that have occurred over the last 50 years in the prevailing economic policy regime. In the post-war decades, multinational companies enjoyed a profile and political significance that reflected policy makers' belief that the future lay with big organisations – in both the private sector and the public sector – that had outgrown market forces and could control their own commercial environments. The disappointing outcomes of this approach have served to show that 'bigness' confers no competitive advantage in itself.

We have consequently moved away from misconceived policies of corporatism and dirigisme to an understanding of the causes of the wealth of nations which tells us that multinational companies are, broadly speaking, as subject to market forces (and also to political forces) as other producers. They are important players, but not necessarily more important, for good or ill, than other economic entities that evolve spontaneously. We have learned that big is not necessarily best: consumers' interests are served simply by efficient businesses, and these vary enormously in size. Equally, our present understanding of public policy shows us how governments can promote (or, if they insist, undermine) the potential benefits of the international activities of businesses.

Imposing special burdens on multinational companies would risk scaring off foreign investment along with its potential benefits. By generating hostility between ourselves and our trading partners, with the possibility of retaliation, it would also diminish our economic and political sovereignty. Similarly, chasing the benefits of foreign investment with concessions like tax breaks and import protection would be self-defeating, would transfer wealth from New Zealand citizens to the shareholders of multinational companies, and would weaken our national sovereignty by encouraging multinational companies to play different countries off against each other in their search for favours.

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<sup>6</sup> Lawrence Summers, 'Summers on Mexico: Ten Lessons to Learn', *The Economist*, 23 December 1995

New Zealand's present policy regime, which combines an openness to foreign investment with a predominantly market-led economy, less regulation and similar treatment of domestic and foreign investment, is ensuring that the activities of multinational companies in New Zealand generally deliver net benefits to New Zealanders. If we continue to follow these rules, multinational companies will be our servants and not our masters, and, in my view, we will have nothing to lose and everything to gain by welcoming them to New Zealand.

**WELLINGTON REGIONAL CHAMBER OF COMMERCE**

**WHAT'S ALL THIS ABOUT GREED?**

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

**WELLINGTON  
27 FEBRUARY 1997**

## WHAT'S ALL THIS ABOUT GREED?

A market economy is often stigmatised as a dog-eat-dog world of selfishness, greed or general amorality. Often this criticism comes from people outside the market sector – such as university academics, public sector workers or various other parties with a claim on the government. And the criticism can be virulent: the stridency of some contemporary critics of markets fully matches the passion of Karl Marx's denunciation of nineteenth century capitalism. For instance, Professor Tim Hazledine of the University of Auckland advises us that the lessons of the post-1984 economic reforms are that "a system based on personal greed and the ruthless egotism of one-on-one competition is not only morally repulsive, it is also bad economics".

A first response to such an extraordinary charge might be to note a very curious asymmetry in the views of Hazledine, Jane Kelsey and the standout band of academic critics of New Zealand's economic reforms – an asymmetry that becomes more puzzling the more you think about it. When people in the private sector follow their own self-interest, they are labelled 'greedy' by such commentators. But when those with a vested interest in the public sector follow their self-interest, suddenly a different standard seems to apply.

Thus when teachers go on strike over a pay claim and children miss out on schooling, I have hardly ever heard the critics of markets describe teachers as greedy. Nor have I when public sector nurses do the same thing and get a pay rise which leaves less public money available for hip operations for needy superannuitants. Nor when university academics obtain a salary increase that pushes up student fees. Nor when tertiary students demonstrate in favour of higher taxpayer subsidies. Nor when firefighters promote a referendum to defend their feather-bedded conditions. Nor when the sons and daughters of well-off elderly people in long-term geriatric care lobby the government to remove asset tests, thus protecting the parental estate and their own future inheritance.

My purpose here is not to condemn all these examples of public sector activity, but to point to some obvious facts. All of the actions I have described are plainly self-interested, and, to the extent they are successful, various third parties are clearly the losers. So why is Professor Hazledine not falling over himself to label this public sector world of self-interested activity "morally repulsive"? After all, a member of the human race does not suddenly change into a member of a totally different and more morally elevated species by leaving the private sector for the public sector. Nor does the economic law of scarcity apply any less in the public sector than in the private sector. We cannot get something for nothing; there is no bottomless pit of resources, and when one group extracts more for itself from the public purse, someone else has to pay. Indeed, arguably the most pervasive form of greed today is that of people who seek to gain other people's money by electing politicians who will take it on their behalf.

Moreover, the alleged 'greed' in the private market economy actually compares very favourably with the self-interested behaviour one sees in much of the public sector. For, unlike organised self-interest in the public sector which ultimately depends on the government's coercive power to tax, the entire edifice of a market economy is founded on the idea of mutual gain. A market transaction – such as purchasing a loaf of bread or a house, taking out a bank loan or entering into a contract of employment – only takes place when both parties to the transaction expect to be better off as a result. Market exchange can take place on no other basis. A market economy is thus a huge network of cooperation, in which people are constantly making themselves mutually better off through trade with one another. People serving their fellow human beings through the provision of goods and services generate income.



The idea of mutual gain through voluntary exchange is one of those ideas which, once grasped, seems so powerful that one wonders why its significance was not recognised a lot earlier in history. For, historically speaking, the principles behind a market economy have begun to be soundly articulated only in comparatively recent times. The Greek philosopher Plato assigned a low ranking to commerce in his ideal state. Aristotle likewise tended to play down the significance of market exchange, since he saw merchants as merely exchanging what had already been produced. It was not until the verge of the industrial revolution in the late eighteenth century that Adam Smith published his classic book *The Wealth of Nations*, which described how the pursuit of profit through voluntary exchange was the social arrangement that maximised benefits to society as a whole.

In the decades following the publication of *The Wealth of Nations*, the wealth-creating potential of an economy based on market exchange under the rule of law was abundantly demonstrated. Entrepreneurs employing new technologies tapped new sources of energy, created and marketed new products, and developed whole new industries for a rapidly expanding population. Most of those who began this revolution came from modest backgrounds. Hardly any went to Oxford or Cambridge; they were not in any sense part of an establishment or an elite. By the light of today's anti-market critics they were displaying 'personal greed and ruthless egotism'. And it comes as no surprise to learn that, in Britain at least, these entrepreneurs were often attacked as 'greedy' by intellectuals and academics of their own time. Often enough they were seen as vulgar upstarts, the nouveau riche who were destroying the old paternal order through selfishness and avarice. But we owe a huge debt to them, because they helped get under way that rise in living standards which lifted millions out of grinding poverty to the levels of advanced countries today.

Like Britain, nineteenth century America also saw people of modest background and often limited education make technological breakthroughs and create businesses that spread wealth and changed radically the material conditions of ordinary people. These early American entrepreneurs were less frequently described as greedy than their British counterparts. From Andrew Carnegie to Bill Gates, the person who starts with nothing and makes a fortune has usually been viewed positively as the embodiment of the American dream – a fact which goes a long way towards explaining why America is one of the richest countries in the world today.

But despite a popular culture favourable to the entrepreneur, the great names of nineteenth century American capitalism – Carnegie, Rockefeller, Morgan, Vanderbilt and others – did not escape attracting labels like 'robber barons' and were accused of living by a 'gospel of greed' by some intellectual and political elites. Yet this is both to undervalue their achievement and completely miss the complex motivations that drive businesspeople. Discussing the so-called 'robber barons' in his latest book *Business as a Calling: Work and the Examined Life*, the Catholic theologian Michael Novak points out that:

What they built was not merely for themselves. They left behind great institutions that have been socially productive for generations after their deaths. These men did more than make money; 'money-making' trivialises what they accomplished. They were not stingy misers, clutching gold coins to their breast, hoarders of gains, petty and avaricious and closed-minded. ... The attempt to understand them under the heading 'greed' reveals both historical amnesia and ideological distortion.

'Greed' does not explain why so many of these men turned to philanthropy, and why Andrew Carnegie progressively gave away his entire fortune. Nor does 'greed' explain the successful businessperson of today. In contrast to many with inherited wealth, most business executives do not live lives of ostentatious consumption or sybaritic luxury, like decadent Roman emperors or minor members of the royal

family. Most top business executives continue to work long after they earned enough to satisfy any personal spending whims. It cannot be greed that drives such people. More likely it is the love of the job and its constant challenges.

Most of those who head New Zealand's largest companies are professional managers, not wealthy individuals in their own right. Yet there is a great deal of adverse comment on the salaries chief executives in New Zealand earn, even though they are typically far below those of their counterparts in many other countries. This criticism is surely quite misguided. Our best chief executives perform complex and demanding jobs which demand rare skills. They must understand complex financial and legal issues, the possibilities of new technologies and the shifting demands of consumers in the markets in which their companies are operating. They must be strategic thinkers yet have sufficient grasp of detail to handle day-to-day decision making. They must also have important people skills and the judgment needed to appoint the right people to the right positions within their organisations. And they must have the personality and leadership ability to inspire and motivate teams around them, to instil a corporate culture and a corporate spirit.

It is a difficult enough job finding a person who is outstanding in one or two of these roles. If someone can perform all of them to a high degree, that person has an extremely high value to shareholders. Just a single inspired decision by an outstanding chief executive can mean far more to a firm's future earnings than that person's total remuneration in a few years of service in a top position: the peak career years of chief executives, like those of leading sports people, are usually short in number. Competition amongst companies to attract such business talent means that rewards to these individuals will naturally be high.

The high rewards that the best managers can earn are in essence no different from the rewards of any other individual whose skills are greatly in demand in a competitive market – a Michael Jordan, Oprah Winfrey, Jonah Lomu or Kiri Te Kanawa, for example. The difference is that we do not know how much Jonah or Dame Kiri earns – rightly, because it is none of our business – whereas the government in its wisdom has seen fit to compel the disclosure of senior executive salaries. This makes the corporate sector a special focus for envy. And when one strips away the rhetoric in which complaints about top business salaries are couched, most come down, at bottom, to that unlovely sentiment.

Yet few things are more destructive of civil society than envy. It is the most sterile of passions and through much of history has set family against family, faction against faction and class against class. Market economies have absolutely no mortgage on the generation of envy. On the contrary: societies where the state tries to allocate rewards on the basis of what people are deemed to need or deserve – an impossible task – are natural breeding grounds for envy. The former Soviet Union was ridden with it. A joke has it that an Englishman, a Frenchman and a Russian were asked what would be their wish if they knew they had only one weekend to live. The Englishman said he would spend the time walking his dog in the woods. The Frenchman said he would spend it with his mistress in Paris. The Russian said he would like to watch his neighbour's barn burn down.

In Western countries most ordinary people (as opposed to intellectuals who purport to speak on their behalf) do not mind a society in which some earn more than others, or in which large differences of artistic, sporting and other natural talents exist. They are not compulsive equalisers. What they find harder to accept with equanimity is the sight of some doing well at others' expense, or a lack of opportunities to do well themselves. Consequently, resentment flourishes during periods of economic stagnation, or when people are denied arbitrarily the opportunity to exercise their talents. Their helplessness to improve their condition strikes them as unfair.

By contrast, during periods of economic growth people see their opportunities and prospects improving and are less inclined to complain that others are doing better. Because a market economy is easily the best vehicle for generating growth, it is the best economic system for combating envy. Moreover, by providing a vehicle for upward mobility, it combats envy in the most tangible way. People can see that in the course of time they and their children will be better off. They understand that hard work, thrift, investment in skills, honesty, reliability and all the other virtues that make a person valuable in a market economy, typically bring rewards to them and their families.

Some people still balk at the idea of endorsing a market economy because they see it as condoning selfishness or immoral behaviour. But that is to wholly misunderstand the market system. Markets are based not on selfishness but on self-interest. When Professor Hazledine buys a loaf of bread from the proprietor of his corner dairy, both parties are better off. Both have clearly acted in their own self-interest but it is hard to see how either could be described as acting 'selfishly'. A market economy is in essence that type of transaction repeated in millions of different circumstances. And the great majority of us – critics and supporters of markets alike – act in our own self-interest in economic matters. We budget, compare prices, snap up a bargain when we see one, and sell our labour to the highest bidder (other things, such as job satisfaction, being equal). Surely none of this is selfish, immoral or greedy.

To observe as a factual matter that people routinely act out of self-interest does not exhaust the question of how any of us *should* behave in all circumstances. The Scottish philosopher David Hume famously pointed out that you cannot derive an 'ought' statement (such as an ethical maxim) from a mere factual description of how things are. But in thinking about the best social institutions, we are well advised to take into account human nature, not as we might like it to be but as it has actually come to evolve in the real world. A social system such as a market economy, which enables people to pursue their self-interest through cooperating with others, fits human nature better than systems that assume no role for self-interest. Moreover, it helps reinforce moral values, since moral conduct is in the long run more in keeping with probabilities of success in business than immoral conduct. However, both the economy and society ultimately rely on moral foundations which are independent of any economic system.

Those who still find a market economy based on self-interest aesthetically unappealing should ask themselves this question: how would a different rule actually work better? Would it really be feasible to try constantly to maximise other people's interests, rather than our own? We know our own interests far better than we know other people's. How would we find out what other people's interests are, and how would we go about advancing them? And whose interests would we give priority to? The information and coordination problems in a world where some class – perhaps the intelligentsia or nomenclatura – is running everyone else's life are formidable compared to those of a market system. Of course a central planner can determine whose interests count, and how each of us is to go about satisfying them. But that is totalitarianism, and its record is not encouraging. Bertrand Russell once pointed out that much of what passes for socialism is usually disguised contempt for 'the lower orders', or disguised love of power.

A civil society inculcates values of self discipline, self reliance, community involvement and support for others – all independently of government. Altruism exists alongside self-interest. It is an obvious fact of human nature that most people empathise with others, and often go out of their way to help people in need. Sympathy for those in distress can be observed in even quite young children. Altruism is most powerful at close range. The closest range is the family: most people care more about other family members than about anyone else. This is why the family is such an important social institution and why it is mistaken to believe that the

collective decision making and resource sharing that occurs in families is a sound basis for organising the wider society.

It is ironic that the critics who claim supporters of market economics ignore altruism include the very people who rushed to condemn the 1980s in America as 'a decade of greed'. For it is these critics who have left altruism out of the picture: it has been estimated that total charitable giving in America rose 56 percent in real terms in the course of that decade – faster than the increase in national wealth. With the worldwide move to freer markets, the 1980s were a decade in which large numbers of people became better off through participation in a market economy. Some people behaved greedily, as they do in every decade. But it takes a vivid imagination to label a whole decade one of 'greed'. In fact, far from inhibiting altruism, an increase in prosperity facilitates it. Wealth increases your options for helping others.

It is pointless to deny that greed exists. It is as well to admit that we are all capable of greed and sometimes are greedy. Yet the antidotes to greed are more powerful in a free and open society than in a managed society. Most of the misnamed 'entrepreneurs' of the 1980s were eventually exposed and punished, sometimes by the law but more often and sooner by the markets. Unpunished greed, in contrast, is possible only where politicians or bureaucrats become involved and disrupt those processes. Even today, nothing beats the rapaciousness of communist cadres in China or Vietnam, or well-connected gangster-businessmen in Russia or Italy.

Of course, no one should ever claim that markets work perfectly, and nor do governments. Winston Churchill once said that democracy is a bad system of government except compared to all the others. The same might be said of the market system. All human institutions are imperfect, because we are inherently finite, limited creatures – despite our undoubted ingenuity as a species. We are limited in knowledge and capacity, and any social mechanism we devise will have features that most of us would rather it did not. It is not a question of which arrangement solves all the world's problems, but which works best amongst the feasible alternatives. Nor is it a question of arguing for some system of unbridled laissez faire: there is a positive role for government to create the legal framework within which markets can function, ensure the provision of genuine public goods and provide a welfare safety net. But governments that intrude unduly on the economic freedoms on which a market system depends choke the system's wealth-creating capacity.

The urge to deny this fact – to believe that we can somehow transcend the trade-offs and compromises of the institutions of civil society – constitutes the age-old allure of utopianism. When people like Professor Hazledine afford themselves such illusions and politicians take notice of them, it is the poor who suffer. We know that a market economy is by far the best mechanism for raising people up from poverty. We know it because we have seen it happen in the richer countries to our own ancestors: most of us need only go back one or two generations to find forbears who were born poor. Market reforms along the lines implemented in New Zealand are making that transition from poverty to wealth a reality in many countries today. As Novak has written:

Business has a special role to play in bringing hope – and not only hope, but actual economic progress – to the billion or so truly indigent people on this planet. Business is, bar none, the best real hope of the poor.

Those who are genuinely on the side of the poor must be on the side of business and the market system and reject the spurious criticisms of greed, selfishness and immorality levelled against them.

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