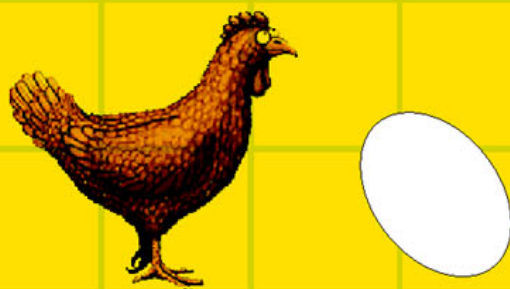
Roger Kerr

DO ECONOMISTS AGREE ON ANYTHING?

and other essays



New Zealand Business Roundtable

Do economists agree on anything?

Roger Kerr

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

This book contains commentaries written by Roger Kerr that were published by various newspapers in New Zealand and Australia between 2002 and 2007.

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About the author

Roger Kerr is the Executive Director of the New Zealand Business Roundtable. He has spent much of his career working to improve the quality of economic policy debate in New Zealand.

When awarding Roger Kerr the NZIER Qantas Economics Award in 2001, New Zealand Institute of Economic Research chairman Michael Walls said:

"No single individual has done more over the last 15 years to persuade important parts of the business sector to support economic policies which, though often contrary to the interests of individual firms, were in the interests of the country as a whole."

As well as the NZIER Qantas Economics Award, Roger was presented with the Tasman Medal by the Melbourne-based Tasman Institute in 1994 in recognition of his contribution to public policy. He is a Fellow of the New Zealand Institute of Management (FNZIM).

Roger is widely published both in New Zealand and abroad, and is often approached to provide his insight on issues in the media.

He is often invited as a guest speaker by a diverse range of organisations.

Before his present role, Roger was a senior figure in both the New Zealand Treasury and the Ministry of Foreign Affairs.

He was a director of the Electricity Corporation of New Zealand from 1986 to 1994, a member of the Council of Victoria University of Wellington from 1995 to 1999, and a member of the Group Board of Colonial Limited in Melbourne from 1996 to 2000.

Roger holds an Master of Arts (first class Honours) from the University of Canterbury and a Bachelor of Commerce and Administration from Victoria University of Wellington.

Part I

2007

Can the media help promote economic literacy?

This article is an appeal to the media.

Speaking to the Journalism Education Association in Wellington recently, prime minister Helen Clark said she wished the New Zealand media were better informed about, among other things, economics.

This seems to be a case of not knowing how lucky she is. New Zealand's rate of productivity growth has slumped on her watch.

Economic management matters to all New Zealanders because the quality of economic institutions and polices fundamentally determines how productive the economy can be.

In a healthy democracy we need penetrating media analysis of economic issues to help citizens assess the economic competence of incumbent governments and parties competing for office.

This need is particularly important in an election year when claims and counter-claims about policy directions abound.

The prime minister is right to suggest that New Zealand has few expert economic journalists. Probably the resources of media organisations don't allow them to employ specialists of the calibre of *The Australian*'s Alan Wood or the UK *Financial Times*' Martin Wolf. Their work is widely admired by academic and professional economists.

However, many media organisations do their best to compensate by featuring economic commentary by qualified people through articles and interviews.

Here journalists could do a better job of sorting out the wheat from the chaff. There is a large measure of common ground in the opinions of respected economists, although there are areas of legitimate debate. And while there are quacks in economics, just as there are in medicine and other professions, it is not difficult to screen them out.

A quick check amongst practising economists would soon establish who they respect among their peers.

Among academics, the names of professors Lew Evans at Victoria University and John Gibson at the University for Waikato would frequently surface. Both would have no trouble getting tenure at leading international universities.

In the area of public policy, the New Zealand Institute of Economic Research has for many years had an annual award for distinguished contributors. A disclaimer in my own case may be in order, but the list of recipients would be an obvious 'go-to' source.

Journalists would also find the Institute's current director, Brent Layton, is highly regarded by his peers.

Regrettably, the Treasury, which employs many economists, can no longer be taken as a reliable source of politically neutral analysis.

As John Gibson has written, “It is no wonder that almost all of the researchers in Treasury have either left or taken secondments so that they spend as little time as possible at No 1, The Terrace. What’s the point, when research is systematically ignored or distorted by politicians? What’s the point, when senior management check which way the wind is blowing before taking a position and will even disassociate themselves from research done in their own department?”

It is astonishing, for example, that the Treasury has not advised the government that pursuing its carbon neutrality targets could do enormous damage to the economy, as research shortly to be released by the Business Roundtable will reveal. Nor does the Treasury appear to have bluntly told the government that its goal of restoring New Zealand to the top half of the OECD income rankings won’t be attained with present policies.

But at least journalists may now have access to researchers who have left the Treasury and are working in other organisations.

On many specific economic issues, journalists would find unequivocal views among economists. On inflation, for example, Nobel laureate in economics Ed Prescott has written that today “All respectable economists agree inflation is a monetary phenomenon.” Thus, contrary to finance minister Michael Cullen’s frequent claims, tax cuts cannot be inflationary given sound monetary management. At most – and even this is uncertain – they might cause a one-off increase in the CPI, not ongoing price increases.

Similarly, Dr Cullen’s claim that New Zealand’s household saving record is poor would find little support among specialists in the field (including ex-Treasury researchers). In fact household net worth has been rising, not falling. Moreover, households also ‘own’ government savings and much corporate savings.

In the run-up to the election, it is particularly important that journalists do their job well.

Former prime minister Robert Muldoon cynically traded on the public’s limited understanding of economics when he said most people wouldn’t recognise a budget deficit if they fell over it, and he went on to wreck the economy.

Today the public better understands the dangers of high public debt, but the hollowness of claims about achieving ‘economic transformation’ and carbon neutrality have not been clearly exposed. And we can ill-afford another election campaign with unjustifiable vote-getting policies like interest-free student loans.

We need the media to shine a spotlight on bogus economic claims by all parties in the election debate. Competent journalists have ample means of doing so.*

*First published in *The Otago Daily Times* on 28 December 2007.

The real downsides of remoteness

The downsides of being a small and remote country are often misunderstood.

Its small population and distance from markets did not stop New Zealand being one of the world's wealthiest countries a hundred years ago. Small, open economies can do just fine.

Much more important are the problems of not knowing at first hand what other countries are doing, and failing to absorb into local institutions and policies the lessons from their successes and mistakes. This is true even in an age of easy international communications and travel.

This dimension of remoteness helps explain why New Zealand governments were able to maintain unorthodox and damaging economic policies for decades up to the 1980s.

Many people saw nothing wrong with Robert Muldoon's eccentric brand of economic management: he kept on assuring voters that he was a competent and successful prime minister, and for three elections they believed him.

I participated in a radio debate with unionist Bill Andersen 20 years ago in which he nominated East Germany as the world's most successful country – just months before the Berlin Wall came down and its economy collapsed.

Opposing labour market reforms around the same time, Council of Trade Union president Ken Douglas saw them as leading to what he thought were the 'coolie' wages of Hong Kong, not realising that its free-market economy had lifted average incomes from the poverty levels of a generation earlier to around New Zealand's levels.

Today annual average per capita income in Hong Kong (PPP basis) is around US$38,200, some 40% higher than New Zealand's US$27,200 level, according to World Bank data.

In pre-reform New Zealand, relatively few people believed the economy could operate like other countries without import protection or foreign exchange controls.

That helps explain why the reforms were controversial, and remain so in some quarters despite the fact that moves towards greater economic freedom have been a worldwide phenomenon and that recent governments have largely kept them in place.

Lately, however, the New Zealand habit of overlooking lessons from abroad seems to have returned, and failure to absorb them is seeing a deteriorating economic trend relative to the better growth and productivity performance of the 1990s.

Finance minister Michael Cullen has kept assuring New Zealanders that the country is doing as well as Australia economically.

Superficially, the argument is plausible. Taking the last decade as a whole, Australia has averaged 3.4% annual economic growth compared with New Zealand's 3.3% rate.

But whereas New Zealand's economic and productivity growth rates have been declining, and the Treasury forecasts annual growth of only 2% over the coming few years, the Australian economy has accelerated to over 4% growth and looks set to continue at around that rate for some time.

Newly elected Labor prime minister Kevin Rudd has embraced the Hawke/Keating reform legacy (which parallels the Lange/Douglas legacy in this country). He has pledged to cut government spending and taxation and has appointed a minister for business deregulation. State Labor governments in Queensland and New South Wales are promoting electricity privatisation, despite union resistance. Victoria and New South Wales are lifting their bans on genetically modified crops.

The contrast with policy directions on this side of the Tasman is striking.

Australia is by no means a standout performer. Over the past decade, Ireland achieved an average annual growth rate of 6.0%, Hong Kong 5.3% and Singapore 5.8%, demonstrating that economies much wealthier than New Zealand can still achieve fast growth.

It is no coincidence that Hong Kong and Singapore have maintained their position as the world's freest economies. Ireland has risen in the rankings while New Zealand has declined.

Greater economic freedom is also behind the spectacular growth rates of China and India, even though these countries remain highly regulated.

The advance of economic liberalism is often unsteady and there have been reversals in some countries, not least in the United States with the 'big government conservatism' of the Bush Administration.

Yet the evidence of its importance for prosperity (and democracy) continues to mount, with many countries cutting corporate tax rates, adopting flat taxes, moving state-owned businesses to the private sector and deregulating industries (in Australia the wheat export monopoly looks set to go).

And it is surprising how little social democratic policies such as school choice in the Netherlands and Sweden and the welfare reforms of the Clinton Administration resonate in New Zealand politics. The tyranny of remoteness remains formidable.

The path New Zealand is on seems unsustainable. If per capita incomes in Australia were to grow at, say, 2% a year on average and only 1% a year in New Zealand, the current gap of 30% in Australia's favour would widen to 40% in less than a decade. On current policies, the outflow of enterprising young New Zealanders to Australia looks set to surge.*

*First published in *The Otago Daily Times* on 14 December 2007.

Good institutions and policies, not mining, account for Australia's prosperity

Speaking on TV One's *Agenda* programme recently, finance minister Michael Cullen said, "Don't forget Australia's wealth is very largely built on its quite crude minerals exports, particularly gas and coal."

This is a serious gaffe for a long-serving finance minister to make, and was surely not one based on Treasury advice. It is also ironic for one who has promoted the 'knowledge economy' and disparaged 'commodity production.'

A quick look at official Australian statistics reveals that the Australian mining sector is far too small to be the driving force of the economy.

In the 2006/07 June year, mining contributed just 7.1% of Australia's gross domestic product (GDP). The definition of mining includes exploration, services to mining, extraction and the preparation of crude minerals for marketing. It covers coal, ores, petroleum and gas.

Because mining is a capital-intensive industry, its percentage share of total employment is even lower – only 1.3% in 2006/07. A moment's reflection indicates that Australia's economic performance can't possibly rest on the shoulders of 1.3% of the labour force.

Mining is far from being Australia's largest industry. Its contribution to GDP is a little over half the size of property and business services (12.2%), 70 percent of manufacturing (10.3%), similar to finance and insurance (7.2%), and a little larger than construction (6.8%).

Of course Australia has benefited recently from the strong terms of trade associated with its hard commodities. In the past five years, these have been estimated to account for around 40% of the total gains in real net disposable income per head in Australia.

However, the comparable figure New Zealand, estimated at about 33%, is not substantially lower, because of price increases in the soft commodities we export.

A breakdown of Australia's economic growth in 2006/07 also helps put mining in perspective. The main mining states, Queensland and Western Australia, contributed 0.9 and 0.8 percentage points respectively to growth in GDP, but Victoria, at 0.7 percentage points, was not far behind and all states made positive contributions.

Moreover, mining growth in Queensland contributed only 0.1 percentage points of its GDP growth of 4.9% (ie about one fiftieth).

And for the Australian economy as a whole, the construction, finance and insurance, and property and business service industries each contributed about as much to national GDP growth in 2006/07 as mining.

The same picture is confirmed by a look at the Australian stock exchange. Only three mining companies, BHP Billiton, Rio Tinto and Woodside Petroleum, are in the top 20 companies on the ASX (and the first two of these are global companies with many operations outside Australia).

Interestingly, the productivity performance of the mining industry does not appear to have contributed in recent years to Australia's GDP growth. Indeed, measured productivity in mining appears to have declined somewhat, due in part to an investment phase (more inputs) in advance of greater outputs coming on stream, and in part to the greater mining 'effort' needed to extract oil and minerals that are in more marginal deposits.

Nevertheless, for the total economy, productivity improvements have been estimated to account for around 40% of Australia's recent GDP growth compared to around zero at best for New Zealand.

It is disturbing that some people still think natural resources determine economic prosperity. Oil-rich Saudi Arabia has been an economic under-performer: its relative per capita income has declined from being over twice Ireland's level 30 years ago to under half Ireland's level today. It is a repressed country in economic and other ways, ranking only as the 85th freest economy in the world on one index compared with Ireland which is in 7th place.

Another striking finding by the World Bank is that New Zealand ranks ahead of Australia and only second to Saudi Arabia for national wealth per capita, partly because of the quality of our farmland.

Australia has always had minerals in the ground. Yet until its economic reforms of the 1980s, which were maintained and extended by subsequent governments, it was also an economic underperformer for many years.

The latest Global Competitiveness Report from the World Economic Forum, which ranks Australia well ahead of New Zealand, puts its standing down to financial and goods market efficiency and the quality of its institutions and education system – no mention of natural resources.

In particular, Australia is ranked 10th in the world for lack of waste in government spending compared with New Zealand which is in 44th place. It is ranked 8th for quality of education; New Zealand is in 21st place.

Some time ago, Fletcher Building chairman Roderick Deane asked the Australian secretary to the Treasury, Ken Henry, what accounted for Australia's economic success. His answer was "good policies." Dr Deane asked, "what else?" The answer was "good policies."

That is the message that Dr Cullen – and any New Zealand minister of finance – needs to take to heart.*

*First published in *The Otago Daily Times* on 30 November 2007.

The priority for tax reforms: a flatter tax scale

Tax cuts are in the news again. The government has signalled that it will move to cut personal tax in the 2008 budget, and the National Party also favours tax reductions.

In assessing the quality of proposals to reduce the tax burden, we should initially focus on government spending.

The government spending share of national income (the ratio of spending to GDP) is the best measure of the tax burden. Ultimately – leaving aside budget surpluses and deficits and any sales of assets – what is spent must be funded from taxation.

Currently, the government is over-taxing New Zealanders and, with public debt at low levels, taxes can be cut by reducing the budget surplus. But ongoing reductions in the tax burden require constraining the rate of growth in government spending to less than the growth rate of the economy.

The adoption of a tax and expenditure limit – a commitment to, say, holding the growth of government spending to no more than inflation plus population growth – would be the best way for a party to demonstrate it is serious about reducing tax burdens.

Given expenditure discipline, how should taxes be cut? Arguably, the aim should be to use tax policy to raise the rate of productivity and economic growth – once the government's 'top priority' objective. The marked slowdown in productivity growth in recent years means living standards in New Zealand are likely to grow slowly, and decline relative to Australia.

The highest effective marginal tax rates are most damaging to productivity and economic growth. These are not just the top personal tax rate of 39% but also those generated under schemes such as Working for Families as assistance is abated.

The so-called 'deadweight' costs of taxation occur because taxes blunt incentives for businesses to invest and innovate and for people to work and save. They rise more than proportionally as tax rates rise – actually by approximately the square of the increase in the tax rate. If the rate of tax doubles, deadweight costs increase four-fold.

Lowering marginal tax rates would boost economic growth. In a recent study for the Business Roundtable covering 98 different countries (available at www.nzbr.org.nz), Australian National University economist Alex Robson found that, "on average, countries which significantly cut taxes on upper incomes between 1980 and 2000 enjoyed per capita growth rates of nearly three times those that did not."

This is why getting down high tax rates is so important. Simply increasing tax thresholds – say the $38,000 and $60,000 thresholds where the 33% and 39% rates cut in respectively – is much less effective.

As the Business Council of Australia, an organisation of chief executives like the Business Roundtable, has put it, "Threshold changes are attractive to governments because they have significantly less cost than rate changes. However, these changes do not provide the benefits the economy needs. It is a change in the marginal rate that impacts on the marginal investor, the marginal decision to save, and the decision to work and for how long (in terms of number of hours and to what age).

"Threshold changes only change marginal rates for a relatively small number of taxpayers. They do not change the marginal tax rates facing taxpayers with incomes above the new thresholds."

The Business Council recommended that all Australian tax rates be reduced to a maximum of 30%. Revenue minister Peter Dunne has also advocated a 30% personal, 30% company and 30% trust structure for New Zealand.

He has pointed to the problems created by the decision to cut the company tax rate alone to 30% next year. This widens rather than flattens the tax scale and creates additional distortions and opportunities for tax avoidance.

In its submission to the 2001 Tax Review, the Business Roundtable went further and proposed a medium-term goal of a 25% tax rate so as to seriously boost the attractiveness of New Zealand as a place to work and do business. Already Singapore has cut its income tax rates to 20% and Hong Kong is cutting the equivalent of its personal and company rates to 15% and 16.5% respectively.

Such tax-cutting strategies, even if they also include cuts to lower rates as they should, are always criticised on the grounds that they favour higher income earners. This is inevitable because they pay more tax in the first place. But such criticisms overlook the fact that lower income earners typically become higher income earners in the course of their careers, and that everyone benefits from a more productive economy. The dynamic countries that have moved to flat or flatter taxes in recent years have overcome envy-driven criticisms of such policies.

The Tax Review put the emphasis on moves to a lower, flatter rate structure, not adjustments to thresholds. It should be used as a benchmark for judging good tax policy.*

*First published in *The Otago Daily Times* on 16 November 2007.

Productivity: New Zealand's biggest economic problem

Writing in the *Australian Financial Review* recently, respected Australian economist Fred Argy noted that Australian living standards, measured by real net national disposable income per head, "have soared by about 16 percent or nearly A$8,000 (NZ$9,500) a person in just the past five years – a great leap forward unequalled in any similar period in recent history."

Argy estimated that about 20% of the improvement was due to rises in the employment to population ratio (increased labour utilisation), 40% to productivity growth per worker, and 40 percent to gains in Australia's terms of trade.

How does New Zealand compare? The answer is, not well.

In the last five years, estimated real net national disposable income per capita grew by only NZ$2,250, an increase of 8% or half the growth in Australia.

Moreover, indicative calculations suggest that most of this modest improvement was due to increased labour utilisation (perhaps two-thirds) and better terms of trade (perhaps one-third). The productivity contribution appears to be around zero at best.

These are striking figures which need further analysis, but they are grounded in official Statistics New Zealand data. They reinforce the picture of New Zealand's productivity slump in recent years and the widening absolute income gap with Australia.

The most reliable evidence of New Zealand's productivity performance is the data that Statistics New Zealand began publishing two years ago on what it calls the measured sector of the economy (essentially the business sector).

This series has recently been extended back to 1978 and growth cycles in the economy have been identified (to remove the effect of cyclical influences on productivity).

The data confirm that labour productivity growth rose markedly following the post-1984 economic reforms, from a low point of 1.4% per annum during the last of the Muldoon years.

In successive cycles it was 2.9% in 1985–90, 2.6% in 1990–97 and 3.5% in 1997–2000.

In the Cullen years 2000–2006, however, labour productivity growth in the measured sector has plummeted to the pre-reform rate of 1.4%.

Moreover, unofficial calculations for the Business Roundtable indicate that the rate may have been close to zero in the most recent year (to March 2007).

All this turns government arguments on their head.

The government came into office claiming that the reforms had failed to raise labour productivity, even though the best available study (in 1999) had reported a "productivity surge" after 1993, "aided by the effects of the labour market reforms of the early 1990s, among other things."

On the basis of this wrong diagnosis, the government declared its aim was to lift productivity growth to raise living standards. In the 2002 budget Dr Cullen spoke of "a broad consensus" to raise New Zealand's sustainable GDP growth rate "in the first instance to somewhere around the 4 percent mark if we are to see a long-term rise in our standard of living relative to the rest of the developed world."

He added, "There is far less consensus about the means to achieve that lift in performance."

The last point is certainly correct. The Business Roundtable (and many others) argued that the government's tax, spend and regulate policies would depress, not raise, productivity and economic growth. The evidence is now unmistakably on their side.

Productivity is ultimately a product of a country's overall institutions and policies. A Mexican migrant to the United States, for example, is on average five times more productive than one who stays at home, due largely to better government, more economic freedom, clearer property rights and greater adherence to the rule of law in the United States.

Research indicates that high taxes are an important reason for the sluggish productivity performance of European economies compared with the United States.

Ironically, the thrust of Professor Argy's article was to argue that Australia's labour productivity record has been "barely average" in recent years relative to comparable countries, partly because reform efforts slackened under the Howard government.

Yet relative to New Zealand, which has gone backward on reform, Australia is now a standout performer with economic growth touching 4%, nearly twice New Zealand's current rate. Both major parties competing for office in this month's election are promising ongoing tax cuts, and many firms are desperately seeking labour.

Unless the productivity-destroying policies of recent years are soon reversed, the exhortation 'Go west, young man' is likely to take on a whole new meaning for many New Zealanders.*

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*First published in *The Dominion Post* on 12 November 2007.

Do economists agree on anything? Yes!

You sometimes hear the line that if all the world's economists were laid end to end, they wouldn't reach a conclusion. This is something of a cheap shot.

True, there are debates in economics, just as there are in any science (take climate change). And in economics there are outliers (and many amateurs), just as there are quacks in medicine.

Also economic knowledge, like other scientific knowledge, evolves over time. Ideas in economics such as Soviet-style central planning and Keynesianism have been discarded over the last generation or so (although there is still no shortage of 'government knows best' advocacy).

Economics is a social science that studies regularities in human behaviour (in households, firms and the wider economy), and how people respond to incentives. Like other sciences, it is founded on theory, empirical evidence and standards recognised by members of the profession.

More so today than in the relatively recent past, there is a broad professional consensus on a range of issues. This is sometimes revealed in surveys (as are areas of dissension).

For example, there is a large measure of agreement among economists that modern economic prosperity is fundamentally dependent on good institutions and policies (such as secure property rights, uncorrupt government and the rule of law). Factors such as a country's endowment of natural resources and its size and location are less important.

Similarly, the debate between central planning and market systems (which was still being waged as recently as the 1960s) is over: most centrally planned economies have collapsed.

Understandings of inflation have been transformed. The Keynesian idea that the sources of inflation were demand-pull and cost-push factors (like 'excess' consumer spending or 'greedy' unions and businesses) was abandoned with the 'stagflation' of the 1970s.

As Nobel Laureate in economics Ed Prescott (who visited New Zealand last year as a guest of the Business Roundtable) has written: "All respectable economists agree inflation is a monetary phenomenon" (in the sense that it won't occur if central banks avoid excessive money creation).

Surveys of economists have routinely revealed strong support for free trade as a matter of policy. This is despite the fact that in theory a number of departures from free trade could yield superior results. The difficulties of designing appropriate interventions and preventing political favouritism make free trade the best option in practice.

Interestingly, free trade illustrates the point that much of economics is independent of ideology: Adam Smith, Karl Marx and John Maynard Keynes were all free traders, and about two thirds of economics professors in the United States (who are part of the consensus on free trade) are reported as voting Democratic.

Another strong consensus of opinion recorded in a recent survey (of American Economic Association members) was against government ownership of enterprises. There was little difference between Democratic and Republican-voting economists. The empirical evidence that, on average and over time, the performance of privately owned businesses is superior to state-owned ones is now overwhelming.

Some other survey findings are interesting.

One found that over two-thirds of economists favour expanding competition and market forces in education by funding government and private schools on the same per-student basis.

Economists are strongly against wage and price controls. One survey of members of the New Zealand Association of Economists also found that 72% of respondents thought that minimum wages increase unemployment among young and unskilled workers.

They also agreed (69%) that the share of government spending in the economy should be reduced.

On some other issues there is more dissension. Economists are divided on climate change, although it may be fair to say that the mainstream view favours cautious early action that could be adjusted over time, depending on future scientific evidence and technology developments that lower the cost of reducing emissions.

They typically favour market-based approaches to pricing carbon and, of these, favour emissions taxes over emissions trading.

Health policy, the optimal level of public debt and the role of antitrust are other examples of areas where economists' opinions differ. And political attitudes (legitimately) influence views on the extent of income redistribution (although most economists would recognise the need to balance the case for income support against the adverse impact on economic growth and the problem of welfare dependency).

Overall, however, opinion among professional economists is less divided on many big issues and less ideological than many people think.

As the author of one survey concluded, "With public discourse so marked by partisan politics, it's useful to be able to look to professional consensus as a somewhat more objective benchmark to learn what most of those with much more knowledge and education in economics than the average TV viewer, newspaper reader or internet surfer generally believe."

Journalists and other commentators could do more to sort the wheat from the chaff in economic debates in this way.*

*First published in *The Otago Daily Times* on 2 November 2007.

Scoring our schools: what makes for a good education

As senior school students across the country prepare for their final exams next month, we already know what some of the outcomes will be: students from independent schools, with only 4% of the country's students, are likely to gain around 16% of available scholarships at Level 4 or higher, and double their proportional number of NCEA Level 3 qualifications; among students leaving decile 10 schools, around 66% will have UE or a Level 3 qualification or higher; while of students leaving decile 1 schools, only 14% are likely to attain these qualifications.

We also know that around half of Maori and a third of Pacific Island students will not achieve a Level 1 NCEA qualification, and Maori male leaver attainment levels, while improving, will still be below all other groups.

Some other facts can also be predicted: many independent schools – notably all-boy primary schools – will continue to struggle with bulging roll; high-achieving public schools will continue their battles with out-of-zoners trying to get in; and a few thousand families will continue to opt for home schooling.

What can we take from these facts? There are many complex factors behind them. But we do know that too many students fail to achieve their potential, that some schools get better results than others, and that many parents, given a choice, will opt for the school they think is best for their particular child.

Parental opinion is one of several key considerations assessed in a new study on school choice outcomes released by the Cato Institute. In *School Choice: The Findings*, Herbert Walberg of Stanford University's Hoover Institution draws on a very large body of evidence on school choice and focuses in particular on achievement test performance, costs, and parental and public opinion. Rather than traverse emotional or philosophical arguments about school choice, Walberg confines his study largely to empirical research on its effects.

Among the 255 studies cited, the book examines the largest single point-in-time study involving nearly every one of the United States' 4000 charter schools and its nearest public school. It finds that many faced numerous handicaps and obstacles, such as heavy regulation and less funding than their comparison schools. Despite this, the charter schools (with over one million students) outperformed their comparison schools. Poor, Hispanic and African American students achieved particularly well, and outcomes improved as charter schools overcame start-up issues and were given more autonomy and funding. All the studies found positive effects on the academic achievement of some groups attending voucher schools and no studies found a negative effect on achievement.

In surveying the effects of private schools, Walberg found they perform better, on average, than public schools at substantially less cost, are more likely to have racial compositions resembling the population in their areas, and greater levels of cross-racial friendship. They also do better than public schools at fostering tolerance, civic participation, and social integration.

Walberg also looks beyond America's borders and examines five other countries' experience of school choice, in each case longstanding, large-scale programmes. His findings are compelling, and confirm similar studies in Ireland, Denmark and Australia.

In Sweden, for example, a voucher system in place since 1993, providing for all schools to be funded on a similar basis, opened up a nationwide educational marketplace. It led to improved student achievement, greater parental satisfaction, and a fivefold increase in the number of independent schools across a broad cross section of neighbourhoods.

In the Dutch voucher system, in place since 1917, the private sector now enrolls 76% of all primary and secondary students. The Netherlands performs well in international test scores and parents report high satisfaction in finding schools that meet their children's needs.

Compared with policies in these social democratic countries, the recent knee-jerk reaction by the government to the idea of involving the private sector more in education seems ideological, not evidence-based.

Walberg also emphasises the importance of parent satisfaction. He argues that parent opinion does and should matter, and demonstrates through customer satisfaction studies that when parents have a choice they are more positive about their school of choice. A recent survey showed that New Zealand parents are far less satisfied with the NCEA than teachers and principals.

In addition to the arguments in Walberg's study, there is also a case for recognising freedom as a value in and of itself in public policy analysis, as argued in a pastoral letter by the Catholic bishops of New York State:

"The purpose of a system of parental choice is to enable parents – all parents – to exercise their inherent right and responsibility to direct the upbringing and education of their children. Even if all schools were high performing, the rationale for a system of parental choice remains. The freedom to choose the education best suited for one's children is a basic right of all parents, regardless of income."*

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*First published in *The Otago Daily Times* on 19 October 2007.

New thinking needed on local government

The 2007 local government elections are now just over a week away.

Early indications are that the turnout may again be low. This may reflect not so much apathy as a feeling of disenfranchisement on the part of voters – a lack of ability to have a real say over what councils do.

Popular frustration with high rate increases gave rise to the establishment by the government last year of the Local Government Rates Inquiry which submitted a 277-page report in August.

There is much to commend in the report. There are strong references to the profligacy of much council spending. It puts the blame for excessive spending largely on councils themselves rather than on central government off-loading functions to local government.

The report correctly notes that many councils are over-providing for depreciation, a point made by the Local Government Forum in its recent report *Democracy and Performance: A Manifesto for Local Government* (available at www.nzbr.org.nz) and by the Auditor-General.

Likewise it dismisses claims that income tax and GST rules favour businesses and recommends that general business rate differentials be abolished. These are politically driven and have no economic rationale.

The Inquiry found that many councils are getting poor returns on their commercial investments. This means capital is being misallocated and national economic growth stunted. It suggested councils could exit port businesses while retaining control over the development of waterfronts.

Other recommendations are also soundly based: that councils should apply user charges for water and wastewater services; that property rates are the best overall tax base for local government; that many Crown exemptions for rates should be removed; that toll options for roads should be advanced; that development contributions and services such as water supply should not be used to cross-subsidise other activities; that rates should not be exempt from GST; and that there should be greater transparency around the allocation of rates to different council activities and to investment returns on council assets.

Some of these recommendations should be well received. A recent *Herald* DigiPoll found that two thirds of respondents favoured more use of user charges.

Overall, however, as Local Government chairman Don Nicolson has observed, "one is left with a feeling of discomfort that the Inquiry . . . is an attempt to defer the community's antagonism with local government but not resolve it – a good but hasty tune-up of a rather badly designed engine."

In part this is because the government put the cart before the horse in focusing the inquiry on funding issues rather than on the proper role of councils and how much they spend.

The Inquiry appears in denial in asserting that the 2002 Local Government Act has not encouraged an expansionary role for councils. Councils are not generally undertaking new activities but in the five years ended June 2007, council spending increased by an average of 8.6% compared with just 3.1% in the previous 5 years.

The report showed no awareness of well-established economic principles that suggest councils should be involved with 'public good' activities (not private goods that can be commercially supplied and charged for) and that central government rather than local government should handle income redistribution.

It was also disappointing that the report did not recognise the key role of sound institutions and incentives that is emphasised in modern writing on public policy.

It did not engage with submissions by a number of parties to examine a better financial framework for local government, even though it acknowledged this was within its terms of reference.

Such a framework could include, for example, a legislative requirement that council spending could not increase faster than the rate of inflation plus population growth unless ratepayers agree otherwise in a referendum. (The Hutt City Council, incidentally, has adopted a similar rule.) The Inquiry's response that it did not favour a cap on rates was superficial, the more so because it stated that rates in real terms need to be held at current levels or reduced. Any belief that councils might behave differently without different incentives represents a triumph of hope over experience.

Legislation could also include a requirement that councils be restricted to a core of defined activities and that any move to go beyond them (for example, to build a stadium) should be subject to specific voter approval.

Moves in this direction would help restore democracy to local government and make councils more accountable to the communities they serve.

The government is yet to respond to the recommendations of the Rates Inquiry. It is to be hoped that it will pick up its more useful recommendations. But its proposals for increased transfers from central government, at a high cost to the taxpayer, are no answer.

Serious improvements to democracy and performance in local government will have to await new thinking and a new local government act.*

*First published in *The Otago Daily Times* on 5 October 2007.

Climate change: minefields ahead

At first sight, the government's response to the challenges of global warming looks responsible and moderate.

And indeed it has some positive features.

The policy is not narrowly focused on electricity generation, as both the government and National were previously advocating, but covers all sectors of the economy and all greenhouse gases.

The government has recognised that a market-based mechanism – an emissions tax or an emissions trading scheme (ETS) – is the least-cost way of reducing emissions, and has opted for the latter.

It has been frank in acknowledging that the costs of the scheme will not fall ultimately on businesses but on households through increases in petrol, electricity and other prices.

And it has wisely abandoned the plan first introduced by National of confiscating the property rights of forest owners in carbon storage (although only for post-1989 forests).

However, leaving aside the scientific uncertainties about global warming and whether adapting to any warming trend would be preferable to combating it, there are still major dilemmas with the proposed course of action.

One is the wisdom of framing policy within the Kyoto framework of placing limits on total global emissions rather than reducing energy intensity – the amount of energy used per unit of GDP. The former strategy, primarily favoured by the European Union, involves unknowable economic costs, whereas the latter, which is more conducive to ongoing economic growth, is preferred by New Zealand's trading partners in the Asia-Pacific region.

A second issue is whether the package is consistent with the government's aim of achieving faster economic growth. The estimate that it would knock only 0.1 percent off GDP over 5 years is unsubstantiated. Moreover, it is based on low projected growth rates, not the government's goal of 4 percent plus annual growth which is necessary if New Zealand living standards are to catch up with those of richer countries.

Thirdly, there is a fundamental lack of logic in seeking to scale back internationally efficient industries such as agriculture, aluminium and steel when the production shortfall may be taken up by industries in other countries that generate greater emissions. From a global viewpoint, it would be preferable on both economic and environmental grounds if, say, dairying expanded in New Zealand and contracted in the European Union.

Fourthly, the reasons given for favouring emissions trading over an emissions tax are unconvincing. A large body of economic opinion favours taxes on the

grounds that they are transparent, provide greater certainty for business, and generate revenue that can be used to reduce other taxes.

An emissions trading scheme is a tax by another name, but it is less transparent and comes with the risk of major price volatility and political favouritism. The adoption of such schemes elsewhere owes much to the aversion of politicians to imposing taxes and to lobbying by vested interests that would benefit from trading (Enron was an early case in point).

Moreover, the proposed scheme is predicated on the development of a broad international market for emissions trading. But, as Greg Mankiw, a former chairman of the US Council of Economic Advisers, recently wrote, "Agreement on a truly global cap-and-trade system, however, is hard to imagine… American voters are not going to embrace a system of higher energy prices, coupled with a large transfer of national income to [countries like China and Russia]." The same may be true of New Zealand voters when they realise the consequences of emissions trading.

Beyond these large questions, a myriad of practical difficulties will arise over the details of a scheme.

The proposed entry of sectors on a staged basis is problematical, both because it would limit the scope for initial trading and because it is based on political judgments about their potential for adjustment, whereas the whole point of a market mechanism is to leave that judgment to market participants.

The plan also involves further takings of property rights without compensation (for example, by penalising farmers who change land use). It fails to recognise the property rights of pre-1990 foresters and the past efforts of businesses to reduce emissions.

Lastly, the task of allocating emissions units and verifying outcomes promises to be mind-numbingly complex, and the timetable for the scheme is rushed compared with the Australian government's intention to bring in such a scheme in 2012.

Much water is still to flow under the bridge on climate change. Voluntary measures to reduce emissions are being taken by many firms and households and no other country has adopted the kind of comprehensive mandatory approach proposed by the government. Greater certainty in this area is desirable, but past mis-steps should be a lesson to both business and government that no policy will be stable unless it is built on sound foundations.*

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*First published in *The Dominion Post* on 1 October 2007.

Back to basics on election funding

Seldom has a bill received such vehement and widespread criticism as the Electoral Finance Bill currently before parliament.

Opposition to its main provisions has come from lawyers, the Human Rights Commission, business organisations, unions and many other groups.

Fundamentally, the bill restricts in draconian ways the ability of private citizens to criticise public institutions and political candidates and to debate matters of public interest during an election year.

It does so by placing extraordinary limits on election-related advertising by citizens or associations of citizens and requiring them to register as a 'third party' with the Chief Electoral Officer. An election advertisement is broadly defined to include taking a position on a policy associated with one or more parties.

So an expression of support for, say, free trade with China is an election advertisement irrespective of whether the person or group taking that position wishes to promote the electoral prospects of one political party or another.

A breach of the proposed law would be deemed a 'corrupt practice' and result in a sentence of up to one year's imprisonment or a fine, or both.

The Business Roundtable did not make a submission on the bill. It would be difficult to add to the volume of damning commentary on it.

Moreover, contrary to the conspiracy theorists, the Business Roundtable is a-political and has never supported any political party, financially or otherwise. Its interests are in promoting good policies, regardless of who supports them. It does not seek political favours, knowing that a proliferation of subsidies and protections almost brought the economy to its knees in the 1980s. None of its research studies or submissions would be caught by any sensible election laws.

Businesses also know they have to deal with whatever government is in office. Corporate election funding is on a declining path, and is often split between parties. At the last election some of the Labour Party's largest donations came from business sources.

In this, organisations representing businesses are different from the union movement. At the last election, unionists such as Andrew Little campaigned overtly against National. How can they expect a sympathetic hearing from a National-led government? The reality is that governments change, which is healthy in a democracy.

The teachers union the PPTA has been reported as spending $130,000 to promote its views in the last election campaign. Union support for the Labour Party has helped secure a number of favours, such as the union monopoly on collective bargaining. However distasteful this may be, few would argue that unions should be constrained in the lawful expression of their views.

The evidence that private funding threatens to hijack the country's election process is weak. The main problems surround taxpayer funding. Contrary to the recommendations of the 1986 Royal Commission on the Electoral System, public funding has supplanted private funding as the main funding source. The Labour Party's use of taxpayer funds for its pledge card was found to be unlawful.

We need to go back to basics on this issue. The right to freedom of political speech should be strongly protected. The secret ballot is jealously guarded because it protects supporters of a losing political party from potential victimisation.

An argument in favour of disclosure of political donations above a certain sum is that a party may be beholden to its supporters. But a counter-balancing argument is akin to the principle behind the secret ballot, namely that privacy is breached and donors may be singled out for retaliation.

There are other considerations, as the legal scholar Richard Epstein pointed out in a Business Roundtable publication *The Concealment, Use and Disclosure of Information*.

One is that regulating the resources available to parties is notoriously complex, given the many forms of assistance (such as in-kind services) that can be supplied.

Another is that there are quasi-market remedies to the problem of influence. As Epstein says, we can ask a candidate repeatedly: "Did you receive money from Brown when you ran for office last time?" If the candidate says, in effect, "I'm not going to tell you because I have something to protect," voters can draw their own conclusions.

The other side of the return to basics should be a close look at public funding and related support. This protects incumbent parties, disenfranchises grassroots supporters and is clearly more open to abuse.

There is a good case for withdrawing the Electoral Finance Bill and starting over. It is a classic example of bad regulatory practice which the Regulatory Responsibility Bill currently before parliament aims to curb.

The Royal Commission said that parliament should not make significant changes to political finance legislation other than on the recommendation of an independent body or inquiry. Public confidence in democracy is undermined if the party in government changes election rules to its own advantage. The government should heed the Royal Commission's advice.*

*First published in *The Otago Daily Times* on 21 September 2007.

Public policy riddles

Two Bedouins are riding their camels through the desert. One of them starts complaining about how slow their camel is. The other responds that theirs is slower. They finally bet on the issue. The oasis is three miles off and they agree that the person whose camel gets to the oasis last wins the bet.

You can see what happens. One of the Bedouins goes slowly, the other goes more slowly so as not to lose the bet, the first one goes more slowly still. An hour later the two Bedouins are sitting on their camels, stock still in the middle of the desert.

At this point, a wise man comes by and asks them why they are sitting in the hot sun when the oasis is only two miles off. They explain the situation. The wise man whispers two words and the Bedouins leap back on the camels and race for the oasis. The riddle is: what are the two words?

This is one of many riddles used by Santa Clara University Law Professor David Friedman in *Private and Political Markets Both Fail: A Cautionary Tale About Government Intervention*, published by the Business Roundtable in 2004. Friedman was illustrating a problem of so-called 'market failure.' This is a situation where individual rationality does not lead to group rationality, in other words where, if each person calculates and acts according to their own interests, everybody will be worse off than if they had acted in a different way.

The answer to the riddle is, of course, 'switch camels.' The bet was which *camel* got there last, so if each of the Bedouins is riding the other's camel, they want it to go as fast as possible instead of as slowly as possible.

The example shows how, by changing the rules of the game, and therefore the incentives people face, the problem of market failure can sometimes be solved without having to resort to government intervention and regulation.

In any society, getting the 'rules of the game' right goes to the heart of what enables people to flourish and what, in turn, enables a country to prosper. By the rules of the game we mean public policy, that is, t he framework of institutions, laws and programmes laid down by the arms of government (parliament, the executive and the judiciary) that regulate the economy and wider social interactions.

Public policy matters because it has a profound impact on the living standards of all New Zealanders and the attractiveness of the country as a place to live, work and do business. Individuals and businesses large and small will only flourish in the long run in a healthy, competitive economy and a strong, cohesive society.

This theme is the focus of *Public Policy: An Introduction*, a new publication released by the Business Roundtable (available at www.nzbr.org.nz) to help policy makers, business people, the media and others understand that it is not

population, location or the level of natural resources that mostly determine a country's long-run economic fortunes. Rather, it is the quality of its institutions and policies that are the key ingredients for economic success.

The study makes the point that understanding the power of incentives in human behaviour is all-important. In other words, structuring rules and institutions in carefully designed ways – the real-world equivalent of switching camels – helps align the interests of individuals with those of the wider community.

Another story illustrating the same point, also from Professor Friedman, concerns a typical household with two cooks. He poses the question: If one cooks the dinner, who cleans up?

It might seem, on the basis of justice and how tired someone is after cooking dinner, as though if they cook, the other person should clean up.

That is probably the wrong answer, Friedman suggests.

The reason, which will be obvious to people who actually cook dinners, is that the amount of cleaning up that has to be done is not predetermined. It depends in large part on decisions made when cooking dinner. Do you use the same pan for three things, or do you say, 'I'm not going to clean up, let's get a fresh pan'? Do you take advantage of the two minutes while the water is coming to the boil to clean up from the previous stage by wiping gunk off the stove before it gets burned on? Because you have choices to make about how you cook the dinner that affect the amount of cleaning up, there is much to be said for the rule: 'Whoever cooks cleans up the resulting mess.' That is fair, too: we just take turns on who does both. That way, whoever does the cooking has the proper incentive to minimise the mess.

The fact that rules have consequences is an important lesson of public policy.*

*First published in *The Otago Daily Times* on 7 September 2007.

Auckland airport not a political plaything

Some of the reactions to the offer by Dubai Aerospace Enterprise (DAE) to take a shareholding of 51%–60% in Auckland International Airport Limited (AIAL) have been emotive rather than rational.

In some cases one might be forgiven for thinking that DAE planned to dig up the land and runway and ship it off to Dubai for use in reclamation!

AIAL was partially privatised in 1998 when the government sold its shares. The Auckland and Manukau city councils retained a shareholding.

The sale was certainly not a 'steal.' In fact the company's share price fell for a period after it was listed. Despite real or imagined anti-privatisation attitudes, the sale was not controversial. The company had languished under public ownership with little investment in facilities. Under private management it has matched NZSX50 returns.

New Zealand First leader Winston Peters was Treasurer at the time of the sale. The issue of whether any foreign ownership restrictions, such as a Kiwi share, should be applied was openly discussed with him. He considered they were unnecessary and told parliament that the airport was a "non-strategic" asset.

Yet Mr Peters issued a statement on 7 August 2007 saying that the airport was a "strategic asset," and that allowing it "to fall into foreign control is not in the national interest." Why is the media not scrutinising such an about-face?

Worse, Mr Peters proposed that the offer should be blocked by the New Zealand Superannuation Fund. The Fund is deliberately set up at arm's length from politicians. It is charged to maximise returns on its portfolio, which requires prudent diversification. It would be irresponsible to make the Fund a political football.

Politicking hasn't ended there. Government minister Phil Goff stepped in to say the government opposed the transaction. Yet legislation requires foreign investment proposals to be considered against stated criteria, and due process – including final ministerial-level decisions – has not yet taken place. Mr Goff's statement caused the share price to fall, and if acted upon would deprive thousands of New Zealand shareholders of the right to accept or decline the DAE offer. This would be yet another unprincipled taking of investors' property rights.

The Auckland councils have so far not taken a position. Polls suggest majority opinion in Auckland is against the sale of their shares. But have Aucklanders been asked whether they would prefer their councils to be passive investors in an airport company or to put the proceeds into infrastructure upgrading or lowering rates? Looking at it another way, if the councils were not shareholders, would ratepayers wish to pay higher rates to be involuntary investors in an airport?

Claims have been made about more New Zealand assets coming under foreign control. However, 35% of AIAL's shares are already owned by foreign shareholders. IF DAE succeed in acquiring more from New Zealand shareholders they will have to pay for them in New Zealand dollars. Sellers of New Zealand dollars will acquire overseas assets in return. Net foreign claims on New Zealand will be unchanged.

Moreover, any owner, foreign or domestic, must comply with the law of the land, so there is no loss of sovereign control.

It is also populist to talk about 'dividends flowing out of New Zealand.' DAE shareholders would want to see a return on their investment just as New Zealand shareholders want to see a return on their investments in overseas companies. Overseas owners commonly reinvest dividends in New Zealand to increase the value of their investments.

There seem no grounds for suggesting returns to DAE would reflect monopoly profits. When privatised, AIAL was not classed as a monopoly by the Treasury. In any event, any potential for monopoly profits should have been capitalised into the initial sale price, and the company is subject to Commerce Commission oversight. Those expressing such concerns should be getting behind the idea of developing Whenuapai as a commercial airport.

Around the world, airports and ports are becoming linked through international ownership. As a recent *Australian Financial Review* article noted, "Dubai already knows it's welcome [in Australia]." DP World [Dubai ports' owner] acquired P&O's container ports at Sydney, Brisbane and Melbourne, and Australia's main airports are privatised with significant foreign ownership. New Zealand's Infratil controls airports in the United Kingdom and Germany. Should it have been blocked from doing so by their governments?

An overseas shareholding might bring AIAL considerable benefits in terms of airport management expertise, tourism growth, employment opportunities and external commercial relationships. This is the case DAE has made to the AIAL board. The responsibilities of the directors are to act in the best interests of all shareholders, and they unanimously supported the offer. They will also have to consider any competing offers that materialise.

The board and shareholders should be left to make their own decisions without political interference and subject to normal commercial rules.*

*First published in *The Otago Daily Times* on 24 August 2007.

Catching up with Australia: policies must match goals

The government came into office committed to raising New Zealand's rate of economic growth. It said that lifting the average incomes of New Zealanders into the top half of the OECD range was its "top priority" goal.

The goal was widely applauded. Only economic growth, driven primarily by growth in productivity, can raise household incomes and support public spending. A recent poll indicated 96% of New Zealanders want higher incomes.

Earlier this year, however, journalist Colin James wrote that prime minister Helen Clark's promise to get New Zealand back into the top half of the OECD income rankings had been "discarded." He was not contradicted by the government.

Why was the promise discarded? Clearly because it is going to be broken. GDP growth in the last two calendar years averaged less than 2% and the outlook for the next two years is around 2% on average. Meanwhile the Australian economy is expected to grow at around 4% this year and next and the world economy is growing by over 5% a year.

Worse, labour productivity growth, which ran at 2.7% per annum in New Zealand in 1992–2000, slumped to 0.7% in the year to March 2006 and was probably close to zero in the latest March year.

Yet some commentators still talk of the economy doing well. The temporary stimulus from high government spending and dairy incomes should not blind them to the weak underlying growth trends and the inflation and balance of payments risks.

We must still hope that the government will recommit itself to its former goal and change policies that are clearly not working. Not to do so would surely be a fraud on the electorate. It is astonishing that New Zealand media do little to hold the government to account for seemingly discarding its "top priority" goal.

The same questions need to be asked of other parties. National has talked of having a more "aspirational" vision. It has focused on Australia as a benchmark. Australian wages and other incomes are around 30 percent higher than New Zealand's on average. Over the past 15 years Australia has moved from a place below the OECD average income rankings to well above the average.

There is no reason why New Zealand cannot do as well as or better than Australia. The quality of a country's institutions and policies largely determine its long-run economic performance.

Asked a couple of years ago why Australia was doing well, Ken Henry, secretary to the Australian Treasury, replied "good policies." Australia's endowment of natural resources is only a bonus. Until it implemented economic

reforms in the 1980s, Australia was an under-performer like New Zealand. Both countries benefited enormously from similar moves to open up their economies, but Australia has continued in a reforming direction whereas New Zealand has backtracked.

Australia's institutions and policies are generally more conducive to growth than the government's and those which National has so far put forward.

As regards institutions, Australia does not suffer from an MMP electoral system (although its senate can be a handicap for a reforming government).

Australia's fiscal policies are much more growth-oriented than New Zealand's. Its ratio of total spending to GDP is around 34%, the second lowest in the OECD, compared to New Zealand's ratio of 41%. The gap is even wider on the tax side with Australia's total tax ratio being 35% of GDP and New Zealand's 43% (almost on a par with Germany). Big government is a serious drag on growth.

Liberal and Labor parties at federal and state level in Australia have continued with privatisation initiatives in areas such as energy, transport and communications. They have also promoted a larger role for the private sector in health, education, roading and water supply. The evolution of climate change policies in Australia is measured. Welfare policies are more restrictive than in New Zealand. In employment law, Kevin Rudd's Labour Party would water down the Howard government's unfair dismissal legislation but would still go further than National's 90-day probation period.

A possible change of government in the forthcoming federal election seems unlikely to change Australia's broad directions. The main difference might be in industrial relations policy. However, Kevin Rudd embraces the Hawke-Keating reform legacy in Australia, whereas our Labour Party has turned its back on its predecessors.

There is plenty to criticise in Australian economic policies, but it is hard to find areas where they are not now in better shape than New Zealand's. Political parties in New Zealand that aspire to the goal of matching Australian income levels must come up with programmes of substance that are capable of achieving that goal. They should not commit further frauds on the electorate.*

*First published in *The Dominion Post* on 13 August 2007.

Kiwis and tigers: lessons in conservation

One of the worst of many mistakes made by European colonists in New Zealand was the introduction in 1885 of stoats. The idea was to control the soaring population of rabbits and hares introduced some 50 years earlier. But today stoats kill, amongst many other things, 40 North Island brown kiwi chicks on average every day. That's 15,000 per year and 60% of the total of North Island brown kiwi born. Another 35% of the chicks are killed by ferrets and other introduced predators.

It's timely, in conservation week, to reflect on this and other major environmental blunders made by our forebears, both European and Maori, in the hope that we've learned something along the way.

Such mistakes were unwitting, of course, and made at a time when people were struggling to make a living from an often harsh and unyielding environment. And there were great successes too; less than 10 years after introducing the stoat our forebears had the foresight to set aside the first of our national parks, Tongariro. This followed the gifting of the volcanic peaks in that region to the government of the day by Te Heuheu Tukino IV, paramount chief of Ngati Tuwharetoa, to be held in trust for the people of New Zealand for all time.

The Department of Conservation is to be congratulated for its wide-ranging efforts to conserve our natural heritage. Much has been achieved. But the task is massive and many of endangered species still hover on the brink of extinction.

And there are many other serious environmental problems in New Zealand, like poor water quality, pollution of streams and lakes, and the use of hazardous substances like pesticides. Many of these come down to mismanagement, under-investment and lack of clear, enforceable, property rights.

As DOC pursues its multiple, sometimes conflicting, roles – as manager of our publicly owned conservation estate, advocate for conservation of private property, operator of facilities like tracks and huts, and issuer of recreational and tourism-related concessions – we should be asking if there are other, better ways of caring for vulnerable land, resources and species.

Some years ago conservationist Guy Salmon suggested that our national parks could be partially privatised. Many of the activities that people enjoy in these parks are provided by the private sector but access to them is subsidised by all taxpayers. Subject to clear rules and contracts, there is no reason why private organisations, environmental groups and iwi could not have a greater role in managing conservation assets.

And government management is by no means the only way to save threatened plants and animals.

Writing in the *New York Times* last year, Indian economist Barun Mitra made a powerful argument for an alternative approach to preserving endangered species, in this case the tiger. He argued that the best way to keep tigers from becoming extinct is to allow them, in effect, to pay for their own survival.

Millions of dollars have been spent internationally in the last 30 years on trying to prohibit trade in the tiger, whose body parts are prized for their use in traditional Chinese medicines. But despite all the effort, the tiger is as close to extinction as ever, and prohibition has, if anything, benefited the poachers and smugglers of tigers and tiger parts.

Mitra argues that if you think of tigers as animals like sheep, deer and cattle, you can see that demand provides opportunity, rather than posing a threat. He points out that while the world's several billion sheep, goats and cattle are among the most exploited of animals, they are in no danger of dying out.

Like these animals, the tiger breeds easily in captivity, and a single farmed tiger is estimated to fetch $40,000. And when Mitra poses the question: "Which country is thinking about applying free-market principles to wildlife preservation and, in the process, improving the survival chances of a long endangered species while giving its economy a boost?," the answer is (communist) China.

Wildlife farming has the potential to eliminate the incentive for poaching, thus protecting those left in the wild, while at the same time restoring the rights of local villagers to earn legitimate revenue.

In Venezuela, a similar approach is underway. Hunters of the endangered Caiman crocodile have turned to crocodile 'ranching,' a strategy that is pleasing conservationists and meeting the needs of indigenous Indians who have long relied on the eggs as a protein source.

The idea of allowing domestication of kiwi and other endangered New Zealand species, though likely less hazardous than tiger and crocodile ranching, may still sound a little far-fetched. But there are surely lessons to be learned, both from our own successes and mistakes, and those of other countries. Applying some lateral thinking and free-market principles could go some way towards meeting the challenges of conserving our natural heritage.*

*First published in *The Otago Daily Times* on 10 August 2007.

Confusion around inflation putting monetary policy framework at risk

Monetary policy is a hot topic right now. The Reserve Bank's decision yesterday to raise the Official Cash Rate to 8.25% will ensure that it remains on the boil.

Inflation is economically and socially destructive. It hurts most those on fixed incomes with no assets. People like Chris Trotter who advocate a softer line on inflation seem to have no regard for its pervasive harms.

The passage of the Reserve Bank Act with its focus on keeping prices stable was one of the pillars of the post-1984 economic reforms. Combined with fiscal discipline and the freeing up of markets, it led to major productivity improvements, stronger economic growth and low inflation, without creating major exchange rate problems, for a decade or so from the early 1990s.

What has gone wrong? CPI inflation has been running at an average compounded rate of 2.7% since 2000, well above the Reserve Bank's mandate to maintain price stability. Over a decade, that means roughly a 30% increase in the CPI – a far cry from a stable price level. At the same time, the exchange rate has climbed relentlessly, putting extreme pressure on many export industries.

Part of the answer lies with the Reserve Bank. In hindsight it misjudged monetary conditions in 2003 when it cut interest rates, and then moved too slowly to tighten monetary policy, with the result that inflation expectations have stayed high. The problem may well have been exacerbated by the increases in the inflation target range (currently 1–3%) in successive Policy Target Agreements.

In addition, the Reserve Bank has created major confusion with its misplaced focus on house price increases, consumer spending, and bank lending, its fruitless intervention in the foreign exchange market, and its misguided search for alternative mechanisms, such as tax policy changes, to curb inflation.

Inflation is not about increases in particular prices such as oil or housing. It is a sustained increase in the general level of prices (or, equivalently, a fall in the purchasing power of money). Hence the saying 'inflation is too much money chasing too few goods.' With its existing mechanisms, which are similar to those of Australia and many other countries, the Reserve Bank has full control over the supply of money and hence over medium-term inflation.

By contrast, changes in tax rules (for example on housing) would only have one-off effects on prices, not on ongoing inflation.

Finance minister Michael Cullen seems not to understand the monetary origins of inflation either when he talks about the economy 'overheating' and the need for activity to 'cool down.' The economy is hardly growing strongly: growth was only 2.2% in calendar 2005 and 1.5% in calendar 2006 and looks likely

to remain subdued this year and next. By contrast, the Australian economy is currently growing at around 4% a year and inflation is well controlled.

Fast economic growth does not generate inflation nor does economic stagnation ease it, as we saw in the 'stagflation' period of the 1970s. Dr Cullen's comments reflect Keynesian 'demand pull' and 'cost push' views of inflation which have long since been discredited.

What has also gone wrong is that policies outside the Reserve Bank's control have made its job harder. 'Monetary policy needs mates' to facilitate non-inflationary growth without creating pressures and imbalances within the economy.

One major source of difficulty has been the massive increase in government spending, up by $21 billion since 2000. This has pushed up costs and prices in the domestic economy and squeezed exporters. There is no way monetary policy can offset these effects.

Other cost-raising measures such as changes to employment law, business regulation, controls on building and land supply, large increases in local body rates and charges, as well as inefficient infrastructure, have compounded the problem.

Finally, there is the issue of 'too few goods.' Labour productivity growth has halved from an annual rate of 2.7% in 1992–2000 to 1.3% in 2000–2006, putting additional pressure on interest rates and the exchange rate.

A parliamentary select committee is currently looking at this range of issues. Business and farming organisations have made submissions to it, stressing the importance of maintaining the current monetary framework and adopting a more balanced policy mix.

The best contribution monetary policy can make to growth is to keep prices stable; it cannot otherwise contribute to the economy's long-run growth performance. New Zealand enjoyed years of strong growth and became one of the wealthiest countries in the world in the late 19th century and early 20th century at a time when the price level was essentially stable.

It is to be hoped that the committee helps clear up the current confusion around monetary policy and inflation and points to remedies to the current problems. Reining in the rate of growth of government spending would be the most effective immediate remedy.*

*First published in *The Otago Daily Times* on 27 July 2007.

Reining in the regulatory madness

More than a decade ago, a Wellington hairdresser was taken to task by the Human Rights Commission for offering haircuts to male pensioners at a cheaper rate than younger, more hirsute customers.

It's easy to find examples of the battles of individuals against the lunacy that regulations inspire in bureaucracies – like the Aucklander attempting to create a duck pond in a soggy section of his five-acre block who was fined $10,000 for an alleged breach of the RMA; or the Taumaranui farmer who faced a fine of $250,000 if he milled a dead totara tree that had been lying in one of his paddocks for 30 years; or the firm denied the right to advertise for a *junior* or a *senior* analyst, but advised that advertising for an *intermediate* would be acceptable.

While some of these incidents are simply absurd, many have been hugely costly and have destroyed people's lives, their businesses and their dreams.

Our statute books are loaded with dubious laws and regulations, which have mushroomed in recent years. Many enable the blatant taking of private property rights without compensation, such as last year's forced 'unbundling' of Telecom's network. Others are ill-conceived and the result of knee-jerk reactions to problems, like the requirement to micro-chip *all* dogs as a way of stopping vicious dog attacks. Some intended to protect people, for example groups of workers, achieve the reverse effect.

To its credit the current government has acknowledged the need to improve the quality of regulation. The strengthened regime for regulatory impact analysis of all policy proposals has been widely welcomed. Commerce minister Lianne Dalziel has promised more 'teeth' for the agency scrutinising proposals, and a more rigorous approach that involves "clearly identifying the problem and objective, considering any existing regulatory frameworks, setting out options, identifying risks and opportunities, always asking whether the response is proportionate, conducting the all-important cost benefit analysis, and consulting on all of these with key stakeholders."

Bold promises indeed, but business groups can be forgiven for feeling a little cynical about the effectiveness of these sharpened 'teeth,' given that this requirement was apparently waived entirely for the Kiwisaver provisions of the taxation bill currently before the House.

Past and current experience shows it is all too easy to bypass or fudge these requirements in the case of politically desired policies. Departments may be unwilling to come up with unwanted findings and, faced with assessing intangible benefits such as 'intrinsic value,' disagreements about costs, special-interest pressures and a lack of clarity about the policy objective, they can readily arrive at a pre-ordained conclusion.

And while cost-benefit assessments of regulations are useful, they raise many thorny issues, such as how much is too much to spend on saving lives? In a 2005 study of the economic analysis of regulation, American Enterprise Institute scholar Robert Hahn found that the cost effectiveness of a range of US health and environment regulations aimed primarily at saving lives varied from less than zero to almost US$36 billion per life saved.

Small wonder then that an alternative and complementary approach to analysing and screening regulations has been steadily gaining favour among business and professional organisations. The proposal was set out in *Constraining Government Regulation*, a discussion paper published in 2001 by the New Zealand Business Roundtable, Federated Farmers and the Auckland and Wellington Regional Chambers of Commerce (available at www.nzbr.org.nz). It proposes a well-constructed regulatory statute, similar in some ways to the Fiscal Responsibility Act 1994, that would not force governments to do specific things but rather would set up principles for them to follow and processes to make them accountable for their decisions.

Last month a version of the idea was embodied in a member's Regulatory Responsibility Bill promoted by Rodney Hide. It passed its first reading by 114 votes to six and is now before the Commerce Committee for public submissions.

The bill proposes a systematic 'decision tree' process for every law and regulation, in which those promoting them will have to answer some basic questions publicly, such as:

- What is the rule for?
- Will it work?
- Is there a cost, and if so, are the benefits greater?
- Does it involve taking someone's private property?
- If so, will they be compensated?

The dog micro-chipping measure, for example, would not get past the first two hurdles.

The same process and principles would be used to assess all existing regulations and the bill would require those responsible for administering regulations to certify a *Statement of Responsibility* for each measure.

It is to our parliament's credit that this bill has been voted through to select committee stage with an overwhelming majority. It's a golden opportunity to improve the effectiveness and efficiency of government, and in so doing promote a society that respects the rights of others and improves incentives to create wealth.*

*First published in *The Otago Daily Times* on 13 July 2007.

Welfare: more a band-aid than a solution to poverty

When Sir Bob Geldof berated the New Zealand government a year ago for its 'pathetic' contribution to alleviating world poverty, he overlooked the fairly generous amount of government assistance to New Zealand's own poor. Our governments have a long tradition of attempting to address inequality and relieve poverty by redistributing national income. Some regard this as a primary means of helping the less well off: it's as if there were a giant, government-baked pie that, sliced up and dished out fairly, could in the end eliminate poverty.

But there is no giant government pie. In reality we are talking about money earned by some and taken as tax to be given as income to others. And both the acts of taxing and giving affect the incentive to earn income in the first place, reducing the size of the pie.

Proponents of redistribution usually have the very best of intentions Local supporters of Geldof's campaign *Make Poverty History*, for example, urge New Zealanders to email their politicians asking them to "consider bringing an end to child poverty in New Zealand." Similarly the Child Poverty Action Group argues that child poverty figures remain "needlessly high," and that through redistribution, the government could "eradicate child poverty by 2010."

But such proponents of redistribution programmes seldom question their effectiveness and their costs and consequences.

A new study released this month by the New Zealand Business Roundtable looks at these issues empirically. *The Outcomes of Income Transfers*, by economist Mark Harrison, concludes that income redistribution is not only a relatively ineffective strategy for lifting people out of poverty, but it is also costly, and has many disincentive effects.

As an example, the study points out that transferring just 1% of income to the bottom 20% of households from the other 80% of households would involve a $900 million transfer, would require an increase in the average tax rate of 6.5 percentage points, and would only increase incomes in the bottom 20% by $3000 a year – and that doesn't take account of the impact of higher taxes and welfare payments on work effort.

In another example, the study looks at what would happen if the government's goal were to raise all incomes to the commonly suggested poverty line of 60% of median income. It finds that this would require everyone's effective marginal tax rate to rise by 47 percentage points. The bottom tax rate would rise from 19.5% to 65.5%, while the top rate would go up from 39% to 86%.

This example again assumes raising the necessary tax is costless, but this is far from the case. High tax rates reduce work incentives and decrease national

income. There are also high administration and compliance costs involved in raising tax revenue and redistributing it.

In this regard, the study cites the enormous efficiency costs of the Working for Families package, which largely redistributes income from single people and couples without dependent children to families with dependent children, many of them on relatively high incomes.

Proponents of redistribution not only understate its costs; they often overstate its benefits. The study finds that while welfare programmes have a role, they have little impact on the distribution of income from a lifetime perspective – the same people often end up paying as much as they receive. Furthermore, they do not address the underlying causes of poverty and indeed may exacerbate them: by discouraging recipients from working and gaining experience, welfare programmes may create dependency and a so-called underclass.

We need to recognise the limits of income redistribution as a means of alleviating poverty. Dr Harrison concludes that a much more powerful strategy is to adopt policies that create wealth and increase living standards, such as pursuing sound macroeconomic policies, reducing economic distortions, establishing flexible labour markets that generate jobs for people willing to work, and providing opportunities to the poor through good education and training policies. Any meaningful approach also needs to focus on non-monetary factors, such as encouraging self-reliance and personal responsibility, and supporting the family and marriage.

Economist Tyler Cowen, writing in his blog Marginal Revolution last week, put the issue as follows: "We don't take steps to redress inequalities of looks, friends, or sex life. We don't grab a kidney from you to save someone's life, even though that health difference was unfair brute luck. Redistribution of wealth has some role in maintaining a stable democracy and preventing starvation. But the power of wealth redistribution to produce net value is quite limited. The power of wealth creation to produce net value is extraordinary. Most of America's poor are already among the best-off of all humans in world history. We should be putting our resources, including our advocacy and our intellectual resources, into wealth creation as much as we can."*

*First published in *The Otago Daily Times* on 29 June 2007.

Not so fast, Minister

Unveiling plans for an emissions trading scheme last month, climate change minister David Parker declared it would be up and running next year, would apply to all sectors of the economy, and would have a "negligible" impact on economic growth. And while noting that no final decisions have been made, he said the government was doing "no work" on alternative policies.

The minister has frequently stressed the need for haste, no doubt reflecting the prime minister's earlier decree that New Zealand must lead the world in combating climate change.

The plan is bold, and the sentiments lofty, but are they based on any detailed analysis or process? Apparently not.

Even Noah, one of the earliest believers in climate change, had a game plan, and must have taken some time to size up the options, design and build the ark, and persuade his passengers of the wisdom on getting on board. Mr Parker has declined meetings to discuss business concerns and only intends to consult with affected parties during the brief six week period while legislation for the scheme is being drafted.

This is hardly consultation in good faith. Business and industry groups took the government's earlier consultation documents seriously and responded with in-depth submissions.

The government's own Cabinet Manual sets out a clear and rigorous process to be followed in the case of a proposal of such significance for New Zealanders. It includes the requirement for a regulatory impact statement and a proper cost-benefit analysis.

There is no sign that these requirements are being taken seriously and that all options are being examined. For example, the option of a carbon tax should be thoroughly analysed: it is supported by leading economists such as Gregory Mankiw, former chairman of the US Council of Economic Advisers and former Federal Reserve chairman Alan Greenspan and by former US vice-president Al Gore. And, given the liabilities New Zealand now faces under Kyoto, the government should be examining whether it should withdraw from that agreement and perhaps seek to join the AP6 grouping which includes China and India as well as the United States. Such a possibility may be politically unpalatable, but that shouldn't be the driver in a decision with such far-reaching costs and consequences.

Given the trail of embarrassing policy failures in this area, such as the aborted methane levy, carbon tax and negotiated greenhouse agreements, and the Kyoto forestry blunder, one might expect the government to have learned from its

mistakes. Businesses were put to great expense over NGAs before they were abandoned.

And it is laughable to suggest that if New Zealand goes out on a global limb, the rest of the world will take note and follow. New Zealand emissions make no discernible difference to global warming, and it should move in line with its major trading partners and competitors.

The Australian government's recently released Task Group Report on Emissions Trading set out a four-year timetable to implement an Australian emissions scheme, cautioning against premature introduction and noting the time required for proper cost-benefit analysis and a comprehensive programme to prepare business and the community for the changes required.

Writing about the report recently, the Melbourne *Age* economics editor Tim Colebatch noted the pitfalls and complexities involved in designing the right one for Australia: "At best, today's report could create a world-class emissions trading scheme, which would cut emissions deeply at a tolerable cost. At worst, it could saddle Australia with a scheme that would create a rortable asset for big greenhouse polluters, do little to reduce greenhouse emissions – and cost taxpayers a fortune to fix later."

Europe took six years to bring in a system significantly less ambitious than the one Mr Parker is proposing for New Zealand, but widely regarded as a fiasco. An April report from the European Economic and Social Committee described it as "a monstrous mess whose only likely effect was to damage European competitiveness with no discernible influence on the climate."

Canada is also considering an emissions trading scheme. Analysing the proposal, *Financial Post* columnist Peter Foster noted that it "sounds great, but when the practicalities of such a scheme are dissected, it falls apart like a Soviet suit."

Such lessons, and the caution with which Australia is proceeding, should have been sufficient to halt the government's headlong rush to lead the world. But it seems this is not the case.

Therefore it is not surprising to see eight major business and industry groups join forces last week to spell out their concerns to the minister. Global warming is potentially a long-term problem and any policies to deal with it need to have a well-established justification, be stable and durable if industry is to plan rationally, and have broad political and community buy-in. At present there is no sign of these conditions being met.*

*First published in *The Otago Daily Times* on 15 June 2007.

Will KiwiSaver boost economic growth?

There is much controversy about whether KiwiSaver is a 'solution' to a non-existent problem of poor savings in New Zealand, and about whether it makes sense as a retirement income policy.

Leaving those debates aside, another issue is whether it will boost New Zealand's economic growth.

Writing in the *New Zealand Herald* after the budget, columnist John Armstrong had no doubts on this score.

"KiwiSaver should reinforce Labour's economic management credentials," he said. "The boost in household savings and the surge in investment capital should drive the kind of growth needed to substantially lift personal incomes – and, in the process, lift New Zealand up those dismal OECD rankings with which National currently flays Labour."

Really?

How should we think about the impact of KiwiSaver on GDP?

Mr Armstrong is clearly thinking of a link between domestic savings, investment and growth. But this is tenuous.

First, New Zealand has access to a vast international pool of capital for investment at a price that is set in world markets. KiwiSaver cannot stimulate investment by reducing the world cost of capital. If it increased domestic savings, firms would simply use less foreign savings.

Moreover, much of any additional saving would not be invested in New Zealand. In the interests of prudent diversification, fund managers are likely to place more than 50 percent of the inflows offshore, as the New Zealand Superannuation Fund does. Domestically, they will have to put most of their equity funds into listed companies. The diversion of savings from other vehicles into KiwiSaver might reduce local funding for sectors like small business and farming. These are amongst the most innovative and productive in the economy.

Even if the funds going into KiwiSaver translated fully into additional investment and were manna from heaven, the impact on GDP would be small.

The capital:output ratio of the economy is about 3:1. The budget puts the build-up of KiwiSaver funds by 2011 at $1,093 billion a year. Assuming the productivity of new investment is the same as that of capital already in place, the effect of $1 billion of KiwiSaver funds channelled into new investment would be an increase in GDP of about $333 million. On this basis KiwiSaver would boost GDP in that year by about 0.2 percent – hardly a big step towards the 4 percent plus growth rate that Dr Cullen is targeting.

But the KiwiSaver funds will not represent net additional saving and will not be manna from heaven.

On the first point, many people will simply switch savings from existing schemes or mortgage repayments into KiwiSaver to take advantage of the tax subsidies. Low income people will not be in a position to save more, despite the inducements.

On the second, the budget estimates the fiscal costs of increasing household savings by $1,093 million in 2011 will be $1,214 million. Taxes will be that much higher in 2011 than they would otherwise be, and will impose a drag (deadweight cost) on the economy. For the purposes of public sector cost benefit analysis, Treasury uses a conservative deadweight cost estimate of 20 percent. On this basis the cost of the additional taxation will slice some $240 million off GDP by 2011.

The contribution of KiwiSaver to GDP is thus looking very small at best, and could easily be negative, having regard to deadweight losses and distortionary effects on savings and investment decisions. Its contribution is clearly negative compared with equivalent tax reductions.

These calculations are illustrative; many refinements could be made. However, they seem consistent with the Treasury's own estimates. In the budget it puts the boost to GDP of KiwiSaver in 2011 at just $68 million, or 0.04 of GDP. Indeed Treasury gets its result largely through an assumption that the tax subsidies will allow some people to accumulate the same level of funds by saving less, so allowing them to consume more!

As an experienced journalist, Mr Armstrong no doubt read the budget and noted this figure. It would be interesting to know how he reached wildly different conclusions.

This is all the more puzzling since it has been well established in the retirement income debate that tax incentives and compulsion have at most a small overall effect on savings – so that the very first premise of his argument breaks down.

I have yet to find any research which suggests Australia's compulsory savings scheme and tax incentives have been a major factor in its economic performance compared with trade liberalisation, deregulation, privatisation, labour market reforms, and sound monetary and fiscal management. It is implausible to suggest that KiwiSaver would have a major impact here.

And because growth in the economy – the output of real goods and services – is what matters most for people in retirement, it is hard to see what KiwiSaver does for retirement income security either.*

*First published in *The Otago Daily Times* on 1 June 2007.

Taming the 'tax, spend and regulate' beast

Yesterday's Budget saw the roll-out of plans for yet another massive increase in government spending. Missing were any moves to lower the tax burden on individual New Zealanders or to loosen the tentacles of regulation that have been strangling our business sector.

This familiar pattern of activity – to expand their role and influence through spending, taxation and regulation – is a natural tendency of governments, and the challenge of constraining it is one many countries face.

A starting point is to ask what we do need government to do. We need it to administer the framework of rules necessary for a well-functioning society. We need it to ensure our lives, freedom and property are protected, to provide a safety net for those with no other means of taking care of themselves, and to provide public goods like police and defence. These are important tasks and we want them done well. But their purpose is to serve the citizens, not to subjugate them or to take over the roles of parents, families, community organisations and businesses.

The propensity of governments to expand and invent new roles for themselves at their citizens' expense is nicely illustrated in a statement made by Helen Clark in 2003: "The government's role is whatever the government defines it to be."

Fourth US president James Madison put the problem very differently: "If men were angels, there'd be no need for government. If angels were to govern men, neither external nor internal controls on government would be necessary. In forming a government which is to be administered by men over men, the great difficulty lies in this: you must first enable government to control the governed; and in the next place oblige it to control itself."

Constraining the Hydra-like 'tax, spend and regulate' beast of government is difficult because it is fed by a myriad of special interest groups, a factor exacerbated in New Zealand by MMP. The Budget, for example, is determined by adding together the costs of a host of separate spending programmes driven by special interest groups.

In his 1979 book *Free to Choose*, the late Milton Friedman described the process like this: "The small number of people who have a special interest in each specific program spend money and work hard to get it passed; the large number of people, each of whom will be assessed for a few dollars to pay for the program, will not find it worthwhile to spend money or work to oppose it, even if they manage to find out about it. The majority does rule. But it is a rather special kind of majority. It consists of a coalition of special minorities."

A constraint supported by Friedman and now in place in various forms in Hong Kong, Japan, the Netherlands, Spain, Sweden, Switzerland and many US

states is a statutory fiscal cap. The idea is to supplement other fiscal management measures (including improving the quality of spending) with a self-imposed limit on tax and spending. Spending can be capped, for example, at the rate of inflation plus population growth, and provision can be made for refunds of surplus revenue to taxpayers. Proposals to increase spending beyond such limits must be put to a referendum, and provisions are made for special circumstances such as national emergencies.

Voters understand this concept well from their personal lives. Most families can't afford everything they want, so they prioritise, and limit their spending to fit within their budget. Governments should do the same.

Tax and expenditure limits (TELs) come in many shapes, with one operating in Colorado widely regarded as among the best. Colorado voters defeated proposals to raise taxes or increase spending every year from 1963 to 1999, but more recently approved some amendments, such as one that increased state aid to public education.

A key virtue of such a TEL is that it shifts the power to increase taxes and spending from politicians to voters, strongly asserting the principle that politicians should not be spending taxpayers' money without their general agreement.

A sample New Zealand Taxpayer Bill of Rights was proposed by the New Zealand Business Roundtable in *Restraining Leviathan: A Review of the Fiscal Responsibility Act 1994*. A similar measure (a Regulatory Responsibility Act) to limit and control the government's propensity to regulate was proposed in another report, *Constraining Government Regulation*, published jointly by the Business Roundtable, Federated Farmers, and the Auckland and Wellington Regional Chambers of Commerce.

Along with widespread business support, political support for these proposals has been growing, with a private member's bill on each now drawn up. Such measures are protections for politicians against the relentless pressure they face to govern in the private interests of particular groups. Parliament should be given the chance to debate measures that would help future governments to govern in the broader public interest.*

*First published in *The Otago Daily Times* on 18 May 2007.

Another Budget of missed opportunities

The budget is, in the first instance, a document which pulls together an overall economic strategy and outlook.

So, the first thing to look for in Budget 2007 is the medium-term outlook, bearing in mind the government's "top priority" goal of moving New Zealand into the top half of the OECD income ladder. In his 2001 budget, Dr Cullen targeted annual growth in real GDP of 4% or more.

The budget confirms that the government is failing to achieve that goal. For the forecast period 2008–2011 economic growth is expected to average a mere 2.5% a year.

There are nasty imbalances in the economy. Inflation is forecast to stay in the top half of the Reserve Bank's target range, meaning monetary policy is likely to remain restrictive, depressing economic activity and putting pressure on interest rates and the exchange rate. There is no relief for the export sector in sight.

The current account deficit is also projected to remain very large, raising risks of a sharp correction and a weaker economy.

The recent trend in productivity growth in the measured sector of the economy (essentially the business sector) has been poor (labour productivity has only grown by 1.2% a year on average since 2000). While the government talks about wanting to improve productivity growth, the outlook seems no better, especially since projected growth rates of business investment are extraordinarily weak at under 3% a year.

The second aspect of the budget is the government's fiscal position and plans. The key issue is not the operating balance but government spending, which has a major impact on the economy.

Here the news is also bad. In the next financial year total operating expenses are projected to rise by $3.8 billion. This is a huge additional bite out of the productive sector, putting pressure on wages, the supply of skilled labour, and other resources. There is also no sign that the government has rigorously assessed whether spending programmes are delivering value for taxpayers' money.

The government has ignored calls by the business community, the OECD and the IMF to slow the growth of government spending and cut taxes more. This would not threaten medium-term inflation, which is a monetary phenomenon. The Reserve Bank can control money. Lower taxes would encourage workforce participation, investment and non-inflationary growth.

The third key element is tax policy. A benchmark for assessing the quality of the government's decisions is the 2001 McLeod tax review, which recommended a lower, flatter tax structure across the board. The top personal tax rate should be aligned with the corporate rate.

Here the government again gets a low score. The reduction in the company tax rate to 30% is welcome, but does not make New Zealand 'stand out from the crowd' internationally. The Business Roundtable has advocated reductions in all income taxes, to a maximum of 25% in the medium term.

Thus the move is a baby step, and is of little benefit to many small firms, farmers and other unincorporated businesses which pay the personal rate rather than the company rate.

The KiwiSaver measures seem more likely to change savings patterns than to increase total savings. The compulsory employer element is a completely unjustified intrusion into voluntary workplace arrangements and, given that the costs will ultimately fall largely on employees, will be resented by many employers and their staff.

The tax measures will also increase the complexity of the tax system. New Zealand is adding about 100 pages annually to an Income Tax Act already 2400 pages long, whereas the entire tax code of Hong Kong, with an essentially flat tax, comes to around 200 pages.

The final key point is that the budget has nothing to say about the tsunami of new regulation engulfing the business sector which is increasing costs and reducing productivity.

All up, this is another budget of missed opportunities. It also scores poorly relative to moves by the government in Australia to reduce regulatory burdens, cut taxes and expand economic freedom – to the point where Australia is now above New Zealand in the Heritage Foundation/ *Wall Street Journal* freedom index.

Economic mismanagement is producing poor outcomes. New Zealand could be doing far better if the government reduced its involvement in the economy and created a freer environment. The time has come for debate on stronger fiscal and regulatory responsibility constraints.*

*First published in *The National Business Review* on 18 May 2007.

How to future-proof New Zealand

A goal of finance minister Michael Cullen has been to 'future-proof' New Zealand: to protect it against the economic consequences of the bulge of aging baby boomers and to protect the welfare state against budgetary stress.

These intentions are admirable, although there is scope for debate around the nature and extent of the state's involvement in the provision of welfare benefits, superannuation, health and education.

In pursuit of his goals, Dr Cullen has run large budget surpluses, reduced public debt, established the Cullen Fund (the New Zealand Superannuation Fund), changed tax rules on saving and encouraged private saving through KiwiSaver.

He has also amended the Public Finance Act to require the Treasury to produce long-term fiscal forecasts every four years in order to increase public awareness of the future costs of current policies and the economy's capacity to sustain them.

Reducing public debt from the unsustainable levels reached under Muldoonist 'borrow and hope' policies has been a task that governments since 1984 have successfully confronted. Public debt is now at low levels by OECD standards, allowing more scope to reduce surpluses and taxes while maintaining prudent debt ratios.

Instead of doing so, however, Dr Cullen's approach has been to lock money away in public or private 'piggy banks' to guard against a future rainy day.

This is a flawed strategy. The Cullen Fund has much higher administrative costs than reducing Crown debt and does not provide a better return when adjustment is made for risk. It does nothing to reduce the total cost of tomorrow's superannuation, invites political meddling, and reduces economic growth relative to a lower-tax strategy.

KiwiSaver also reflects a 'piggy bank' mentality. It is based on another 'government-knows-best' premise: that New Zealanders should be saving more in the form of financial assets than by repaying mortgages, building up a business or investing in work-related skills.

The fundamental problem with Dr Cullen's thinking is that putting coins in piggy banks won't future-proof New Zealand.

The living standards of future retirees and the quality of health and education services depend on the productivity of the economy now and in the future, not on money put away today.

This may not be intuitively obvious. Take superannuation. Surely if governments have promised future benefits, and even partially pre-funded them, and people have a nest egg of their own, their future security is assured?

Alas, no. What matters for retirees is what goods and services are available to them, that is, the level of future output. As an IMF paper puts it, "pensioners are not interested in money (ie colored bits of paper with portraits of national heroes on them), but in consumption – food, clothing, heating, medical services, seats at football matches, and so on. Money is irrelevant unless the production is there for pensioners to buy."

What's more, the purchasing power of superannuation benefits, even if they are pre-funded, can never be guaranteed. Governments can 'raid' piggy banks and erode benefits through inflation, tax changes and in many other ways. Those of working age will vote out any government that puts an intolerable tax burden on them to support retirees, or migrate. That is why future productivity and output matter, not the size of the Cullen Fund.

Politicians like Michael Cullen have also been concerned not just to redistribute income to those in need but also to middle and higher income voters in order to shore up voter support for the welfare state. Working for Families is a classic case in point.

But this policy also promises to make future generations poorer by reducing the returns from working and making more people dependent on the state. The costs of large-scale redistribution are high and the productivity performance of state-run monopolies such as health is poor. Paradoxically, the strategy being followed is likely to make the welfare state as we know it less sustainable.

The upshot is that future-proofing New Zealand requires a quite different strategy, one focused on economic growth through lower tax rates, more competitive provision of social services, and more modest redistribution.

In turn, economic growth on a long-term basis depends mainly on raising labour productivity. Here Dr Cullen's record is underwhelming. Under his stewardship labour productivity in the business sector of the economy grew by 7% in total in the six years to March 2006, whereas the increase in the previous six years was 18%. The outlook is for further mediocre growth on current policies.

In pursuing the worthy goals of underwriting the living standards of New Zealanders in the future and the provision of government-provided social services, it seems likely that Dr Cullen is in fact putting both at risk. Only a departure from a piggy bank mentality and a focus on productivity and economic growth will reverse that outlook.*

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*First published in *The Dominion Post* on 17 May 2007.

Across the Tasman: Australia rising

Speaking last week to the Queensland Media Club, Australian prime minister John Howard described the sort of world Australians would be living in a decade from now, and his vision of “an Australia rising to new heights” to meet its challenges.

In a speech full of energy and optimism, Howard urges Australians to work hard to retain their country’s place in a fiercely competitive global economy, to stay engaged in the global battle of ideas, and to continue to face up to the hard choices and trade-offs that are necessary if Australia is to remain a land of opportunity, social mobility and prosperity.

“There’s no reason why Australia should not be even more prosperous by the year 2020,” says Howard. “But it means becoming even more competitive through economic reform. It means keeping the size of government and our tax burden down on workers and risk takers. It means keeping downward pressure on inflation and interest rates through budget discipline and a flexible workplace system. It means creating the conditions for growth so business will continue to invest and create jobs.”

After 16 successive years of growth and a steady rise in incomes that’s put their country in the top tier of the world’s economies, Australians might be forgiven for taking a tea break at this point, but there’s no such suggestion coming from their political leaders, or for that matter from mainstream Australian media.

Instead politicians and commentators alike regularly remind Australians that the job is never done, and that there should be no roll-back of the reforms that have kept Australia’s economy growing. “Any step back,” says Howard, “will see Australia fall behind in the global economy, reducing our capacity to create jobs, to innovate, to care for the sick and the aged and to help those who need a leg up in today’s competitive world. This is not simply an economic argument. It lies at the heart of our quest for a better society.”

Howard openly acknowledges that Australia’s success story has been the work of both sides of politics in government. “Looking back, broad consensus surrounded the need for five great structural reforms to give Australia a shot at prosperity in the 21 st Century. They were financial deregulation, tariff reform, privatisation, tax reform and workplace relations reform. And I’ve always paid credit to the former Labor government for its reforms in the area of financial deregulation and tariffs.”

Speeches like Howard’s are in stark contrast to the muted language of political leaders on this side of the Tasman. The P word (privatisation), for example, appears banned by politicians of all persuasions, and the critical reforms undertaken here by both Labour and National governments of the late ‘80s and

early '90s often seem air-brushed out of political history. Even parties who supposedly embrace the need for further economic reform step gingerly around the topic in public.

Compare that, for example, with the mantra of rising Australian Labor Party leader Kevin Rudd, who talks comfortably about concepts like privatisation and tax reductions – and even some elements of workplace reform. His proposal, for example, to exempt businesses for varying lengths of time from unfair dismissal procedures, even though it waters down the Howard government's moves, puts him ahead of the National Party's policy of a 90-day probation period.

The Australian public and their politicians are regularly challenged to aim higher by a media equally at ease with discussing the structural transformation behind Australia's boom and keen to see the country continue to enjoy rising prosperity.

Why are New Zealand politicians and journalists so reluctant to challenge this country to do better, so apparently afraid to spell out what we know is required to lift our game and get moving on a track like Australia's, the same track that brought us gains that are now eroding?

Back to Howard's clarion call: "It's critical that Australia not slip back to the ways of the past... I want Australia in 2020 to still be the best country in the world in which to live, to work, to start a business and to raise a family... We are here in the Asia Pacific region, a region that will be the cockpit of history in the 21 st Century. It will be a world of intense competition for markets and global talent... Australia may never be the most powerful nation in the world, but we can be an even greater nation than we are now."

Australia still has many issues to grapple with, but our political leaders have much to learn from its success. As they watch Australia rise to new heights on all the international measures of freedom, prosperity and quality of life, while we drift steadily backwards in the rankings, New Zealanders should be listening carefully to the language – and the ideas – of winners.*

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*First published in *The Otago Daily Times* on 4 May 2007.

Still plenty of scope to get people into work

There is confusion about why the economy did well from the early 1990s; why the outlook is now poorer; and why we could do better not just through higher productivity growth but also by getting more people into the workforce.

Some of the confusion arises because commentators fail to distinguish between business productivity, which is measured and grew strongly from 1992 to 2000, and public sector productivity, which is unmeasured and likely to be poor. Economy-wide indicators of productivity are misleading as indicators of business productivity

There is also confusion about the sources of output growth. Reacting to the abysmal figures on recent business productivity growth, David Skilling of the New Zealand Institute said, "Most of New Zealand's economic growth in the last 15 years had been achieved by growing the labour force ... productivity growth has only counted for a third of the overall growth, while the other two-thirds has come from getting more people working longer hours."

However, the Statistics New Zealand figures for the measured sector of the economy indicate that under a quarter of output growth has been due to increased labour supply. As the release stated, "From 1993 to 2006, GDP growth was relatively strong, averaging 3.8 percent on an annual basis. This reflected positive growth from all three contributors: labour input contributed 0.9 percent annually, capital input contributed 1.2 percent, and multifactor productivity increased 1.7 percent on an average annual basis."

Brian Easton made the same error when he wrote that "we have to move from a low productivity growth/labour extensive growth strategy to a high productivity one because the sources of additional labour are running out."

But New Zealand's measured productivity performance since the early 1990s is shaping up as a game of two halves. The trend annual rate of growth in labour productivity in 1992–2000 was 2.7 percent a year and trend multifactor productivity growth was 2.3 percent.

During the present government's term of office, these figures have slumped to 1.2 percent and 0.7 percent respectively as policies of high spending and taxation, increasing regulation and other forms of intervention have impacted on the business sector. When the productivity figures for the year to March 2007 are available, they are also likely to show weak growth.

And are "sources of additional labour" running out?

This seems unlikely. It is true that employment growth as well as productivity growth surged after the Employment Contracts Act freed up the labour market, and that unemployment fell sharply.

However, the general unemployment rate still stands at 3.7 percent of the labour force (82,000 people) while a broader measure shows that a total of 161,800 people are jobless. The Maori unemployment rate is 7.2 percent and the youth unemployment rate is 14.3 percent. The economy is well short of full employment.

There have also been increases in the numbers on sickness, invalids and other benefits. The total of all people of working age on benefits remains high at almost 265,000. Many in part-time jobs would prefer more or full-time work, and many displaced older workers struggle to get re-employed.

Factors such as mandatory unfair dismissal laws, the inability to write straightforward fixed-term contracts, and the anti-discrimination provisions of the Human Rights Act perversely militate against the interests of older workers.

While New Zealand's workforce participation rates are relatively high, a 2004 Treasury study found that there is scope for increasing participation, especially among young women. It concluded that raising overall participation to the average of the top five OECD countries would increase employment by over 140,000 and GDP by over $6 billion dollars or 5 percent.

Regrettably, the situation seems likely to deteriorate rather than improve. As Westpac economists have recently noted, the incentives for labour force participation are heading in the wrong direction.

They suggest that the participation rate is likely to fall because the high effective marginal tax rates generated by the Working for Families package will discourage people from working. The increase in annual leave (from 3 to 4 weeks) will further restrict labour supply. They estimate that these effects, combined with population aging, will knock at least a full percentage point off yearly growth in labour input over the next 5 years.

The implications for New Zealand's economic growth outlook are bad. With productivity growth and labour force participation both flagging, the GDP growth rate of 4 percent plus that finance minister Michael Cullen targeted in his 2001 budget is nowhere near in sight.*

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*First published in *The Otago Daily Times* on 27 April 2007.

It's time to cool it

Thirty-two years ago, Tom Wolfe, author of *The Bonfire of the Vanities*, attended a university conference titled 'America in the Year 2000' that featured a series of grim forecasts of life in the future. Writing about it some years later, Wolfe described the final symposium where a young ecologist announced he would rather not be alive in America in the year 2000. Due to the rape of the upper atmosphere by aerosol can users, he explained, a certain ion would no longer get through the atmosphere to the earth, and this particular ion was indispensable for bone formation.

"No bone formation!" wrote Wolfe. "Suddenly I had a vision that was worse than any that had come to me in the preceding 36 hours. I could see those marvellous women that I enjoyed watching walk down Lexington Avenue near where I live in New York City with their five-inch, pyramid heel, three-colour, patent-leather, platform-soled shoes, and their blue jeans, and I could suddenly picture them dissolving into blobs of patent leather and denim on the sidewalk, inching and suppurating along like amoebae. And I could see the blind news dealer down at the corner of Lexington and Sixty-First Street trying to give change to a notions buyer from Bloomingdale's, and their hands run together like fettucine over a stack of *New York Post*s. It was worse than anything I had ever imagined in my life."

Mercifully, we appear to have averted this dire threat. But today's doom-mongers have shifted their sights to an equally scary prediction: global warming, bringing melting polar ice caps, calamitous weather events, malaria epidemics, extinction of some species, loss of habitat for humans – the chief scientist of Britain's Labour Party has even gone so far as to predict that by 2100 the Antarctic could be the only habitable continent, with a few surviving breeding couples left to propagate the human race.

This is over the top. Alarmism such as in Al Gore's movie has been widely discredited, as has the Stern Review. The likelihood of extreme scenarios is low, and the human capacity to mitigate and adapt to trends over time is high. There is a strong consensus among leading economists internationally that aggressive early action is unjustified.

The New Zealand economy is too small to affect global emissions, and it is pretentious to think New Zealand can much influence the policies of major countries. Moreover, the stark reality is that there are currently no low-cost ways of materially reducing New Zealand emissions, and action could hit low-income people hard.

New Zealand should not be the last cab off the rank in taking policy action, but nor should it be out in front. Households and firms are already responding

to climate change, independently of government. But to be a responsible international citizen and protect its commercial interests, New Zealand should move in line with its major trading partners, in particular Australia and the United States.

What is needed as a foundation for sound policy is a careful analysis of the case for policy action, recognising that moderate warming could benefit New Zealanders in many ways. Unless such a case is established with widespread buy-in, we will see further botched initiatives such as the aborted methane and carbon taxes and the Kyoto forestry fiasco, and ongoing policy instability.

If and when further action is warranted, a broad-based approach covering all sectors, and the use of market mechanisms (such as a low carbon tax), would impose the least economic costs. Agriculture and transport should not be exempt. The Business Roundtable and other major business organisations oppose the current proposals for applying an emission permits regime narrowly to the electricity sector, which could see electricity prices doubling or trebling, and to take the property rights of forest owners in carbon storage without compensation.

Among all the hot air in the climate change rhetoric is the government's lofty goal of 'carbon neutrality,' an idea that bears no relationship to reality. Ministry for the Environment figures (included in the Business Roundtable's submission available on www.nzbr.org.nz) suggest that even if New Zealand were to shut down the whole of its agricultural sector, and to ban the use of all cars and other transport, and even if economic growth were to stop entirely (contrary to the government's 'top priority' goal of faster economic growth and higher incomes), achieving carbon neutrality would be unattainable for the foreseeable future.

New Zealanders are as likely to opt for such a scenario as they are to plan for a mass evacuation to the Antarctic or for Tom Wolfe's vision of life without bone formation. A cool-headed approach based on rigorous science, proper policy analysis and much more consultation is required to establish the costs that New Zealanders are willing to bear to support action on climate change.*

*First published in *The Otago Daily Times* on 20 April 2007.

The lever of riches

The human body has many amazing features that enable us to create wealth. We can labour with our limbs and muscles. We can manipulate objects with our hands. We can use our brains to reason, imagine and invent. And we can use our spirit and individual talents to comfort, inspire, create and entertain.

The work we all do, the way – and how well – we use these attributes is the key determinant of the country's productivity, and thus how well we live. By ensuring as a nation that we're doing what we do best and trading for the rest, we improve productivity and our standard of living.

Productivity, described by American economist Joel Mokyr as the "lever of riches," is a hot topic these days, and rightly so: it's the single most important contributor to reducing poverty, increasing leisure time and meeting health, education, environmental and cultural needs.

That's why New Zealanders should react with alarm to the news last week that the rate of growth in labour productivity (that's the amount of goods and services produced from each hour of a worker's time) was the lowest on record. Whereas we had strong growth in productivity (2.7% a year on average) following the reforms of the 1980s and early 1990s and up to the year ending March 2000, in the last six years that figure has fallen to an average of 1.2%, and an all-time low of 0.4% for the year ending March 2006.

What drives productivity? Trade and competition play a powerful role. Open markets force businesses to perform better. Resources shift to their best uses. Through trade, firms can access cheaper inputs, tap into larger pools of capital and technology, expand their markets and take advantage of economies of scale. The scope is limitless.

Low taxes and the absence of stifling regulation also encourage productivity growth. They give people the incentives and capabilities to be entrepreneurial and improve their lot.

Improving worker training and knowledge, having better technology or more capital to work with, making best use of natural resources and inventing new ways to do things increase productivity. Henry Ford's development of the assembly line in 1913 is a popular example of a spectacular productivity leap: it reduced the number of hours required to make a car from 17 to one and a half, dramatically cutting the cost of production and making the car affordable.

Ford's invention effectively pushed his workers up the 'hierarchy of human talent.' With the creation of machines and tools that can perform tasks better and cheaper than human muscle and basic brain power, people move to jobs that use other, more sophisticated human talents like creativity and people skills. At the same time, manual jobs like sewing machining, assembly line work and

telephone operations shift to lower-wage countries where workers can perform them more cheaply. In this way the economy sheds 'lower order' jobs, and adds 'higher order' jobs like nurses, lawyers, chefs, recreation and hospitality workers, designers and architects, hair stylists and beauty therapists, financial advisors, tourism operators, and so on.

Such changes in the talent hierarchy inevitably involve turmoil. It's not surprising that many people cling to the status quo and want to preserve old jobs at all costs. But if society is to reap the gains from productivity and enjoy a rising standard of living, it has to endure the upheaval.

In 1800, 95 of every 100 Americans were needed to feed the country. By 1900 it took 40. Today it takes just three, and the United States, with less than 5 percent of the world's population, produces almost 25% of the world's food.

New Zealand has a similar story. At the close of the twentieth century, with a vastly reduced share of the labour force, we produced 2000 times more butter, 40 times more lamb and 500 times more beef than we did a hundred years before.

There were wrenching changes for American and New Zealand families caught up in the exodus from farming back then. But long hours of toiling in the fields have given way to shorter work weeks in a dizzying array of new jobs, producing an equally dizzying array of goods and services. And no one today would seriously advocate ditching tractors and other farm machinery and returning to shovels and hoes, any more than we'd want to go back to old-style telephone exchanges or typewriters. Work would be harder, prices would be higher and wages would be lower.

So why the fall-off in New Zealand's productivity? It's clear that, despite its stated goal of lifting productivity in the interests of raising New Zealand incomes to the top half of the OECD, the government's strategy is not working. High government spending and taxation, increasing regulation, more restrictive employment law and many other interventions are hindering the changes that are the lifeblood of productivity. Countries, like New Zealand, that impede the 'lever of riches,' not only fall behind in the race for competitiveness and productivity but in the living standards of their citizens.*

*First published in *The Otago Daily Times* on 23 March 2007.

It's getting better all the time

It's official: never before in human history has humankind had it so good. By every objective measure of human well-being – be it availability and price of food and other basic necessities, access to clean air and water, rates of infant mortality and child labour, life expectancy, health, wealth, social mobility, quality of environment, economic and political freedom, literacy or educational attainment – the quality of life is getting dramatically better for billions of people all over the world.

In a giant setback for the global doom-mongers' movement, eminent American economist Indur Goklany has collected in one volume the long-term trends in the most significant indicators of human and environmental well-being. The evidence is compelling. In *The Improving State of the World: Why We're Living Longer, Healthier, More Comfortable Lives on a Cleaner Planet*, Goklany demonstrates that, contrary to popular belief, global economic growth, free trade and technological change have led to unprecedented improvements in the human condition.

Goklany's optimistic account of the world's progress turns a number of modern myths on their head. For example, the most striking improvements have been experienced not in the developed world but in the poorest countries. The rates at which hunger and malnutrition have been decreasing in India and China are stunning. In the 40 years to 2002, China's food supply has gone up by 80 percent. India's has increased by 50 percent since 1950. Chronic under-nourishment in developing countries has fallen since 1970 from 37 to 17 percent, despite an overall 83 percent growth in their populations.

Also at odds with the popular doom and gloom view is the fact that the gap between rich and poor countries is rapidly closing. Fifty years ago a child born in a poor country had a life expectancy 25 years shorter than their counterpart born in a rich country. Today, thanks to health practices developed in and transferred from the West, the gap has halved.

Of course, of course . . . the pattern is not universal. The main exceptions are countries that lack democracy, the rule of law and free markets. Goklany deplores the appalling deprivation, hunger and disease that continue to afflict many millions of people in sub-Saharan Africa and other mismanaged countries. But, he argues, that should not stop us from celebrating the extraordinary global achievement of liberating even greater numbers from extreme poverty.

The book, published last December by the Cato Institute, contains a massive range of information. From charting the fall in cholera outbreaks since London's Great Stink of 1858 (when the stench of rotting sewage in the Thames caused

parliament to recess) to the rise of affordability of holidays in the developing world, Goklany documents the positive impact of progress.

Consider the following: over the past century the retail prices of flour, bacon, and potatoes in the United States relative to per capita income have fallen by 92 percent, 85 percent and 82 percent respectively. The real global price of food commodities has dropped by 75 percent since 1950. In the last 30 years, global illiteracy has fallen from 46 to 18 percent. Life expectancy in India has almost doubled since the 1950s, from 39 years to 63 years. Over the past century, average life expectancy worldwide has risen from 31 years to 67. Infant mortality rates in the poorest countries have fallen since 1980 from 147 deaths per 1000 births to 53 per 1000. Improved technology has led to energy conservation, a reduction in noxious emissions and amazing gains in the productivity of farmland, with the United States, for example, feeding three times as many people with a third fewer farmers on a third less farmland than in 1900.

While noting that the record on the environmental front is complicated and that the early stages of development often cause environmental problems, Goklany reaches a firm conclusion that must surely strike cheer into even the gloomiest corner of the green movement: as countries become wealthier they also become healthier, cleaner and greener.

To those who warn that all these gains will be lost with the costs of human-induced global warming, Goklany responds with rigorous modelling that shows the benefits of faster economic growth in the developing world will far outweigh any such costs. If we allow globalisation to continue, he argues, we could soon be living in a world where "hunger and malnutrition have been virtually banished; where malaria, TB, AIDS and other infectious and parasitic diseases are distant memories; and where humanity meets its needs while ceding land and water back to the rest of nature ... even in sub-Saharan Africa infant mortality could be as low as it is today in the United States, and life expectancies as high."

You have to admit, in the words of Lennon and McCartney, it's getting better, so much better all the time.*

*First published in *The Otago Daily Times* on 9 March 2007.

Monetary policy, inflation and capital markets

Promoting discussion and public understanding about monetary policy and financial markets is important. A stable currency and the efficient allocation of capital in the economy matter for economic growth and living standards. There is room for fair debate about relevant policy issues.

Some things are clear. One is, in Milton Friedman's famous formulation, that "inflation is always and everywhere a monetary phenomenon," in the sense that it cannot occur without a more rapid increase in the quantity of money than in output. Central bankers should recite these words to themselves every morning.

It is hard to over-emphasise the importance of this insight, which has revolutionised thinking and practice worldwide in the last 25 years. The defeat of inflation through better monetary policies has been of enormous benefit in many economies, including New Zealand.

Inflation is an ongoing increase in the general level of prices, not the relative ups and downs in prices that occur all the time in a market economy, and are so important for its functioning.

Friedman's point is that inflation cannot be sustained unless the central bank accommodates an increasing demand for money. It alone is responsible for controlling the money supply and thereby inflation.

To be sure, there are long and variable lags in the operation of monetary policy, as Friedman also pointed out: These may have changed in New Zealand with the growth in fixed-rate mortgages. However, that does not change Friedman's basic point; the Reserve Bank simply has to use its best judgment about them in assessing whether or not to tighten monetary conditions.

The extent of this revolution in monetary thinking is apparent when we look back on earlier government reactions. In the 1960s and '70s when inflation increased worldwide, governments in New Zealand and elsewhere responded to inflationary pressures with expedients such as wage and price controls and ceilings on bank lending. None of them worked more than temporarily. Disinflation was not achieved until governments moved to what we now regard as orthodox monetary policies targeted directly at inflation.

We seem to be at risk of forgetting earlier lessons. In recent years the Reserve Bank has talked a lot about housing prices, consumer spending, debt and the balance of payments. The minister of finance has canvassed the idea of a tax on home mortgages, and has resisted tax reductions on inflationary grounds.

Recent levels of inflation and inflationary expectations are indeed a matter of concern. However, their source is much more likely to be the Reserve Bank's tolerance of an excessive growth in the money supply and the successive moves

to loosen the Policy Targets Agreement. Persistent inflation of around 3 percent per annum is not consistent with the legislated goal of price stability.

House price increases by themselves should not be a matter of concern from a monetary policy perspective. New Zealand house prices have risen less than those of a number of other countries. In many respects they are an outcome of the better performance of the economy since the early 1990s, rising employment, positive net migration and historically low real interest rates. Farm prices and those of other assets have risen too. There is no reason to discriminate against lending to any sector. In respect of housing, the focus instead should be on key distortions such as council policies and RMA processes that are restricting land supply and making new houses much more expensive than they should be.

Tax policies need to be determined by sound tax policy criteria and not be confused with monetary policy issues. Changes in taxes can have one-off effects on asset and goods prices but they cannot affect the ongoing rate of inflation. We saw this with the introduction of GST. Whether countries impose capital gains taxes on housing or not, for example, makes no ongoing difference to their inflation performance.

Thus discussion of New Zealand's non-resident withholding tax on interest or the Approved Issuer Levy, to take another example, should focus on whether they contribute to raising necessary government revenue at the least economic cost. Relative to debt, the priority would appear to be a reduction in the level of taxation on equity investment, which pushes up the cost of capital in New Zealand.

There are also many issues that affect the efficiency and depth of New Zealand's capital markets, not the least of which has been spiralling regulatory costs in recent years, the extent of government ownership of commercial enterprises and levels of government spending and taxation that have crowded out private saving. Again, however, these have nothing to do with ongoing inflation.

The bottom line is that when it comes to inflation, the buck stops with the Reserve Bank. Its charter needs to be defended and it must execute it competently. Other policies should be considered on different criteria. Misguided policies in respect of labour law, business regulation, government spending, tax, land supply, building controls, infrastructure and many other things can make the Bank's job harder, but their main impact is not on monetary policy and inflation. Rather, it is to undermine economic growth and make New Zealanders unnecessarily poorer.*

*First published in *The Independent Financial Review* on 7 March 2007.

Tax cuts, inflation and saving: confusion piled high

Finance minister Michael Cullen argues against significant tax reductions on the grounds that they would be inflationary.

In response, some have suggested that tax cuts could be quarantined by channelling them into savings through the KiwiSaver scheme, so reducing demand and inflation pressures.

This would be to compound one economic error with another.

Responsible tax reform should not be inflationary.

First, if tax reductions were largely offset by reductions in government spending, there would be no adverse implications for demand and inflationary pressures.

Secondly, likely tax cuts would only represent a small proportion of the economy.

In recent years the government has allocated around $2 billion for new spending or tax reductions. Instead of offsetting tax reductions with spending cuts, suppose that allowance were split 50:50 between the two (the government has talked of the business tax package costing around 1 billion).

Currently the size of the economy is around $160 billion. So tax cuts of the order of $1 billion would represent only around 0.6 percent of the economy – hardly an amount likely to cause overheating.

Moreover, tax cuts of $1 billion would be less of a threat to inflation than spending increases of $1 billion because part of them would be saved. The proportion saved could be expected to be higher if they were focused mainly on reductions to the 39 and 33 percent tax rates, as the Treasury has recommended.

Thirdly, the argument assumes that firms would respond to an increase in demand by raising prices. However, competition in New Zealand has increased substantially in recent decades. The days of blanket import protection are over. Firms that face competition from imports can't easily raise prices. The prices of exportable goods and services are also fundamentally set in world markets. Imports and exports are now a significant share of the economy. Statistics New Zealand estimates that the tradables component of the CPI is 46 percent. Therefore tax cuts could at most have an impact on 54 percent of the CPI (making the reasonable assumption that they would have no significant effect on the exchange rate).

Fourthly, and most importantly, inflation – which is an ongoing increase in the price level – is a monetary issue, not a fiscal policy issue. A one-off increase in the price level is not inflationary unless the Reserve Bank prints money. It alone

is responsible for controlling the money supply and thereby inflation. Inflation is not the fault of home buyers, businesses or unions.

The United States and Australia are two countries that have cut taxes in recent years while keeping inflation low. In 2005 the governor of the Reserve Bank of Australia stated that despite four rounds of tax cuts since 2000, "Fiscal policy has not been a significant influence on monetary policy at all in Australia for the last six or seven years. Whilst ever there are not big swings in the fiscal position in either direction it has not been a factor that we have really had to take into account in our monetary policy."

If the argument that tax cuts cause inflation were valid, we would presumably hear calls for tax increases to take pressure off interest rates. Such calls are notable for their absence.

The simplistic idea that tax cuts boost demand (ie spending in the economy) and hence inflation reflects outdated Keynesian economics. (Paradoxically, Keynes was worried about too much saving – the last thing he would have wanted was to channel tax cuts into compulsory savings arrangements.)

It also overlooks their effect on the supply side of the economy. Growth-oriented tax cuts increase the speed limit of the economy, allowing faster non-inflationary growth. Cuts in personal and company tax would reduce wage and cost pressures and increase investment, so easing capacity constraints.

It is odd to hear the argument that tax cuts are inflationary when back in the 1980s they were regarded as deflationary. Governments in both Australia and New Zealand were promoting so-called 'wage-tax trade-offs' – reductions in taxes to reduce the need for wage increases and thereby inflationary pressures.

A sound programme of tax reform would involve a phasing of reductions over a few years. Such an approach would not be inflationary. It follows that there is no case for denying people the opportunity to use tax reductions as they wish, and to attempt to force people to put them into savings.

How people decide between present consumption and savings (consumption in the future) is not the government's business. People's circumstances vary greatly. New Zealanders are not poor savers; KiwiSaver is a cumbersome solution to a non-problem.

The government should stop over-taxing productive New Zealanders (our tax-to-GDP ratio is now nearly as high as Germany's), constrain spending and regulation to make the Reserve Bank's job easier, cut taxes and leave people freer to decide what to do with their own money.*

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*First published in *The Otago Daily Times* on 9 February 2007.

Capital market regulation: less is better

There has been much handwringing about the state of New Zealand's capital markets. Typical laments have been the paucity of initial public offerings, the delisting of some major companies, and the acquisition of mid-sized firms by foreigners as they out-grow the New Zealand market.

These have been accompanied by calls for more government intervention.

There are issues for debate here but, like the guns of Singapore in World War II, much commentary is pointed at the wrong targets.

Some claims are particularly naïve. A common one is that Australia is awash with investible funds due to its compulsory savings regime, and as a result Australian firms are taking over New Zealand businesses.

But Australia has been running a sizeable current account deficit, indicating that it has a deficit of savings relative to investment. There are similar laments across the Tasman that foreigners are hoovering up Australian firms and that Australia is becoming a branch economy.

This is populist nonsense. In many respects the current account deficits of Australia, the United States and New Zealand are a sign of economic health: these countries are attractive to foreign investors who are willing to supplement domestic savings. The current account surpluses of Japan over the past decade have been a sign of a sick economy: Japanese savers have wanted to put their money elsewhere.

'Branch economy' talk is equally shallow. Ireland is sometimes described as a branch economy of the United States, but foreign investment has brought skills, technology and market linkages to Ireland, and been a major factor in its strong economic performance.

In an era of globalisation, economies and businesses are increasingly linked, reflecting the gains from specialisation and trade. It makes no more sense to call New Zealand a branch economy of Australia than to call Taranaki or Southland a branch economy of Auckland.

Contrary to some commentary, savings have been encouraged in New Zealand by moves such as an anti-inflationary monetary policy, the introduction of GST, lower income tax, and retirement income policy changes. The best evidence available indicates that New Zealand households are generally saving at adequate levels to fund their retirement, given current retirement programmes.

Moreover, there are no grounds for intervention to actively favour future consumption (the purpose of saving) over current consumption. Such action would be particularly harsh on people with low or modest incomes who already have enough trouble making ends meet.

In Australia, aggregate and household savings rates have both fallen since compulsion was introduced. And even if forced saving promoted economic growth (which is dubious), why would it make more sense than forcing people to work longer hours to increase output?

The McLeod Tax Review of 2001 found there was no evidence that New Zealanders are poor savers, and no subsequent inquiry has overturned that finding. It advised against the kind of special inducements for saving that the government has introduced.

The main issues lie elsewhere.

High rates of increase in government spending and over-taxation have reduced the potential growth of private savings.

Capital markets are suffering from over-regulation. The Sarbanes-Oxley legislation in the United States has seen the New York stock exchange lose business in favour of centres like London and Hong Kong. There are now moves to relax it.

The New Zealand stock exchange promoted or acquiesced in similar regulation in New Zealand, despite the absence of Enron-type problems. Takeover regulation, mandatory publication of executive salaries, continuous disclosure and more onerous audit requirements have pushed up costs and made public markets less attractive.

Private equity has been boosted as a result. Some of the best and brightest in business, like Graeme Hart, have gone private in the interests of privacy and greater freedom of business operation. The less regulated exchange Unlisted has attracted business.

Besides the Business Roundtable and the Shareholders Association, few voices criticised the expropriation of property rights in the Telecom unbundling legislation. There are similar proposals to expropriate forest owners' property rights by preventing land conversion. Tax on foreign equity investment raises the cost of capital to New Zealand firms. The government is opposed to privatisation on ideological grounds. None of this is good for New Zealand's capital markets.

In a recent Business Forum article, Rob McLeod noted that, in general, business lobbying in New Zealand has changed from promoting special interests to a concern for the national interest. A respected commentator observed that capital market lobbyists were an exception.

A focus on overall national interests, and on worthwhile goals such as lower and flatter taxes (which would encourage savings and reduce investment distortions in favour of housing), stronger property rights protection, the sale of government commercial operations, and less regulation would do more for capital markets than yet more ill-conceived intervention.*

*First published in *The Dominion Post* on 29 January 2007.

Stern review on climate change is bad economics

The review of the economics of climate change under British civil servant Sir Nicholas Stern, released on 30 October, has created headlines around the world.

The government appealed to its findings in putting forward a battery of proposals related to its Kyoto commitments before Christmas. But how reliable are these findings?

The Review calls for urgent and drastic action on climate change, claiming that acting now might cost 'only' 1 percent of world GDP whereas doing nothing might devastate economies, cutting between 5 and 20 percent off global GDP.

The Review's estimates of possible damage are far higher than those of other climate economists, while its projections of the costs of reducing emissions are lower. Why?

Essentially there are two reasons.

First, the damage numbers rest on extreme assumptions and worst case scenarios.

The Review takes as its starting point the proposition that the scientific evidence on climate change is now overwhelming, and that new evidence has yielded new grounds for alarm.

No amount of repetition of this mantra will make it true. Media reports suggest that this year's IPCC report, which comes only 5 years after the last one, will reduce overall estimates of global warming by 25 percent and halve (from 34 inches to 17 inches) the predictions for sea-level rise by 2100.

Such swings in the space of 5 years, coupled with the fact that atmospheric methane levels appear to be declining, contrary to IPCC assumptions, and that there has been no global warming since 1998, hardly suggest settled science.

The Review presents estimates of increased damage from hurricanes and flooding if nothing is done. But critics such as sceptical environmentalist Bjorn Lomborg have pointed out that these risks can be mitigated far more cheaply by simple initiatives such as measures to strengthen buildings and control flooding than by taking costly action to cut carbon emissions.

Lomborg also points out that Stern appears to accept the estimate of Yale University's William Nordhaus, a leading climate economist, that perhaps 3 percent (around a year's growth) will be cut from global GDP over the coming century if nothing is done.

But he inflates this estimate by assuming carbon emissions will continue at high rates into the following century and by exaggerating the possible impacts of warming.

A second aspect of the Review that has attracted much criticism is the assumed discount rate – the rate used to compare the well-being of future generations with the well-being of those alive today.

Stern uses a very low discount rate factor that gives almost as much weight to the interests of future generations as to those living today. Thus the benefits far into the future of measures to reduce global warming are made to exceed current abatement costs.

This procedure accords neither with the reality of how people vote nor with their individual decisions. Eminent Cambridge economist Partha Dasgupta has pointed out that it implies that British citizens should be saving 97.5 percent of GDP (compared with the current UK saving rate of 15 percent), independently of global warming. As he says, this is an absurd figure: it implies the current generation should impoverish itself for all that follow.

The choice of a low discount rate has radical and nonsensical implications.

If consistently applied, it would call into question any income redistribution policies such as Working for Families since these reduce economic growth and hence the income levels of the relatively poor in generations to come.

Similarly we should scrap taxes on capital because of their growth-reducing effects.

As Nordhaus has written, "If we were to substitute more conventional discount rates used in other global-warming analyses, by governments, by consumers, or by businesses, the Review's dramatic results would disappear."

Even action to curb carbon emissions costing about 1 percent of global GDP would involve large sums.

For New Zealand, it would mean an annual cost of over $1000 a household.

It is little wonder that, given the minimal effect such action by a limited number of countries would have on global temperatures, governments are unwilling to impose such costs and are violating their Kyoto obligations.

The risks of climate change cannot be dismissed. They should be evaluated through sober analysis, not political alarmism or lobbying by self-interested parties, including businesses and consultants. Policy should be calibrated to reflect assessments of the net benefits of 'insurance' against possible future economic and environmental harm.

The Review offers a kind of cost benefit analysis, albeit a flawed one. None has been produced in a New Zealand context. The government's latest proposals still lack any assessment of the kind that is supposed to accompany regulatory proposals.

The Stern Review is far from being an authoritative guide to the economics of climate change. Like the infamous 'hockey stick' analysis used in the IPCC's last report, it is likely to end up discredited.*

*First published in *The Otago Daily Times* on 26 January 2007.

Achieving the dream

A 'dream-catching' survey of 10,000 New Zealanders conducted just on a year ago revealed that our beaches and empty spaces are the number one pride-trigger for Kiwis. Staying 'unspoilt' and 'clean and green' also rate highly in our top ten dreams and aspirations.

Those of us lucky enough to be going bush this summer would do well to reflect on the threats to those spaces and dreams, and some of the solutions we could be embracing if we want to preserve the Kiwi way of life.

A new study released last year by the Business Roundtable offers compelling evidence to support the role of markets in finding solutions to environmental problems, and warns against the impact on the foundations of market economies of 'command and control' responses to environmental threats.

In *Environmentalism Versus Constitutionalism: A Contest Without Winners* University of Queensland professor of public law Suri Ratnapala weighs the threats to the environment that, if unattended, can endanger our way of life, against the threats to constitutional government and the economy that can arise from managerial-style responses to the challenges of environmental protection. He argues that in the end such responses will not only diminish our freedom and weaken our institutions but will also end up harming the environment by reducing our capacity to deal with real threats.

In backgrounding the arguments, Dr Ratnapala notes that the difference between prosperous and struggling countries can primarily be explained not by disparities in their natural resources or good fortune, but by the difference between their respective institutions. Prosperous countries tend to have a relatively high degree of personal safety, property rights and contractual certainty under the rule of law, while in stagnant economies these things are generally not secure and the rule of law is feeble.

He observes that the power of market economies underpinned by strong institutions in helping to move people from poverty to prosperity is well understood. But he notes that the role of markets in helping societies overcome problems created by human activity – including environmental harm – is often overlooked.

The report discusses three ways through which markets can help address such problems: the free exchange and vigorous debate of ideas and information; innovation and technology-driven solutions enabled by wealth creation; and market processes based on property rights and the law of contract that are superior to 'command and control' measures as mechanisms for the efficient allocation of scarce resources.

An important background feature of the report is a discussion of the current environmental debate which highlights one of the major obstacles to a proper consideration of the legal and policy issues.

In Dr Ratnapala's view, a specific impediment to discussion of the issues is the claim of consensus, the perception that the debate regarding the existence and scale of threats to the environment is over, and that we have no choice left but to embrace the command and control agenda.

He challenges this claim and argues that we are more likely seeing the beginning of the first serious public debate on the subject, and that it is not in the interest of science or humanity to silence the alternative points of view on these issues.

While emphasising that we should aim to have a healthy environment and should prevent harm that is preventable, Dr Ratnapala cautions against extreme environmentalist views that pursue an imaginary, past, pristine condition of the Earth at the cost of all other interests.

The study goes on to examine the state and impact of law in New Zealand and elsewhere with respect to the regulation of property use and the question of compensation, as well as the arguments of those who support regulation and the subordination of property rights to other interests.

It notes that New Zealand's Resource Management Act 1991 replaces the common law approach with a micro-management control system that is, in Dr Ratnapala's assessment, "a mixture of indeterminate rules, discretions, overarching policies and unstable judicial law generated by breadth of discretion bestowed on the court."

The study finds that New Zealand's current resource management laws and related policies are eroding constitutional government in New Zealand, and impacting negatively on the economy and ultimately on our capacity to find the most appropriate responses to environmental problems.

If we consider the biggest environmental problems in New Zealand today – poor water quality, pollution of streams and lakes, use of hazardous substances like pesticides, and the threat to native species and farming posed by uncontrolled pests – a common thread is clear: they all come down to mismanagement, neglect, under-investment and lack of clear enforceable property rights.

If New Zealanders are serious about living the clean green dream, there is wisdom in the view that we should back off our current, bureaucratic system of environmental management and place more weight on a framework of clear and fair rules whose management is entrusted to democratic institutions and independent courts.

Dr Ratnapala's report can be found at www.nzbr.org.nz.*

*First published in *The Otago Daily Times* on 12 January 2007.

Part II

2006

Roger Douglas: visionary leader

Last month's Deloitte/ *Management* magazine awards included for the first time a category of 'visionary leader.' The award went to Sir Roger Douglas, finance minister from 1984 to 1988 in the reforming Lange-Douglas government.

Two things about the award are of immediate interest.

First, when Douglas's name was put forward to the judging panel there was apparently unanimous support for it.

Second, the announcement to the audience of 800 was met with warm and prolonged applause.

Such a reception 10–15 years ago would have been unthinkable – more likely there would have been hisses and boos.

Douglas, in the opinion of the judges, is the politician who, in the past two decades, has had the most impact on the business community and the country.

They cited as among his achievements the dismantling of external trade barriers, the floating of the dollar, the establishment of a framework for stable monetary and fiscal policies, internal deregulation to force more competition into the New Zealand economy, and the reform of the public sector (including the corporatisation and privatisation of many state-owned businesses).

"In their earlier incarnation a huge drain on the taxpayer," said the judges, "they are now virtually all profitable, taxpaying, dividend-paying, stand-alone enterprises."

Douglas's reforms, complemented by stronger fiscal discipline and the freeing up of the labour market in the early 1990s, produced today's more efficient and flexible economy.

Instead of the high inflation, stagnant growth, mushrooming public debt and growing unemployment of the 1970s and early 1980s, New Zealand has enjoyed until recently a lift in its productivity growth rates that has matched Australia's, low inflation and unemployment, a high credit rating with prudent levels of public debt, and widespread improvements in per capita incomes.

The changes were painful for many businesses and families, and the reform programme was far from perfect – for example, the Labour government's failure to free up the labour market due to union resistance unnecessarily increased unemployment.

But perfection is an unrealistic standard in democratic politics; on any reasonable measure, New Zealand's reforms score highly for both their conception and execution.

According to the judges, Douglas gave the country something that was "in line with a vision that most people – in fact more and more people – look back on now thankfully.

"Many people opposed his policies, whether they were farmers or in corporations. Only a few leaders of companies said that they would back him."

Contrary to claims that the changes were forced on an unwilling electorate, the inconvenient truth is that the Labour government was returned in 1987 with an increased majority. It campaigned on a promise to finish the job. David Lange's subsequent abandonment of Douglas put an end to policy coherence, weakened business confidence and the economy, and ultimately led to the fall of the Labour government.

"What was extraordinary about [Douglas] was that his vision transcended political parties," said the judges. "The fallout from that has changed the political face of New Zealand as well."

One measure of the change is the shift in the policies of all political parties, reflecting changes in public opinion. In the early 1980s almost all our political parties espoused policies similar to those of the former Alliance. In the 2002 election the Alliance disappeared, winning just 0.7% of the vote.

Some have not appreciated the extent of this shift. The Christchurch *Press* recently editorialised that Don Brash's retirement from politics marked the "last gasp of Rogernomics." How absurd. Those who would dismantle Douglas's legacy today – Green activist Nicky Hager is possibly one – are on the political fringes.

The true test of a political leader is what they did to make the country a better place, not how long they stayed at the top of the greasy pole of politics.

Keith Holyoake was a prime minister of long standing, but his term of office is now seen as largely a time of lost opportunities, as the country avoided change and drifted into economic difficulties while the rest of the world moved on.

This lesson should not be forgotten. Although there is plenty to criticise about the Howard government's economic management, this year it has gone beyond New Zealand in some ways in freeing up its labour market, cut taxes significantly, fully privatised Telstra and foreshadowed the deregulation of the single desk for wheat exports.

Nothing comparable has happened in New Zealand. The country is clearly not on a path to getting back into the top half of the OECD income rankings; the government no longer even talks about trying to achieve what was once its 'top priority' goal.

In his modest but tireless way, Douglas wanted to be in politics to make a difference. His honourable place in the New Zealand history books is assured. Few politicians since his time seem likely to be able to claim that status.*

*First published in *The Otago Daily Times* on 15 December 2006.

Loss of a freedom fighter

When Milton Friedman died in San Francisco on 16 November 2006 at the age of 94, tributes flowed around the world.

In a popular sense, he was arguably the most famous economist of the last 50 years, and among the foremost of economic scholars.

Born in New York to poor immigrant parents, Friedman graduated from Rutgers University and went on to do postgraduate studies and teach at the University of Chicago, where he did most of his scholarly work.

His contributions to economic science were recognised by the award of the 1976 Nobel Prize for Economics. Among them was his book *A Monetary History of the United States*, co-authored with Anna Schwartz.

The book showed that the Great Depression of the 1930s was not, as was once commonly presumed, a 'market failure' that demonstrated the instability of capitalism and called for the guiding hand of government.

Rather, it was a failure of government policy. The contractionary monetary policy of the US central bank turned the 1929 sharemarket crash into a banking collapse with economic consequences that seared Western politics for more than a generation.

Friedman played a major role in rescuing economics from the pervasive Keynesian orthodoxy that followed the depression years. With others he argued that there was no long-run trade-off between inflation and unemployment. His work explained the 'stagflation' of the 1970s and helped prepare the ground for the implementation of stable, medium-term monetary policies that tamed the scourge of inflation in the 1980s.

But Friedman was much more than a monetary specialist. He also championed the case for free markets, and helped create the intellectual climate that led to the Reagan and Thatcher revolutions and worldwide moves to greater economic freedom.

In this he was a moderate who recognised important roles for governments such as maintaining the rule of law, protecting property rights, safeguarding the environment and underwriting the incomes of the poor.

And he was an advocate for liberty well beyond the economic sphere. He campaigned for the abolition of compulsory military service in the United States, and was a lifelong supporter of school choice.

Friedman became a household name in the late 1970s with his popular book *Free to Choose* and the television series of the same name. The series exposed his gifts as a lucid exponent of economic ideas and a formidable debater.

Some of Friedman's bons mots, such as "there's no such thing as a free lunch," have entered popular discourse. "Inflation is always and everywhere a monetary phenomenon" is an abiding insight.

With his wife Rose, Friedman spent 10 days in New Zealand in 1981. I recall his patient exposition of social credit monetary theory in response to a question at a public meeting in Wellington, followed by a crushing demolition of the concept.

From occasional subsequent contacts I can attest to Friedman's unfailing courtesy, cheerfulness and generosity with his time in support of liberal ideas.

Among the outpouring of tributes to Friedman, one particularly resonates.

Gary Becker, another pre-eminent Nobel Laureate and longstanding colleague at the University of Chicago, wrote as follows:

"There are various ways to describe Friedman's influence. But one way is to ask, 'Has he helped many people – poor people in the world?' And I would just take India and China, 37% of the world's population. Hundreds of millions of people in these two countries, who used to live on less than one dollar a day or two dollars a day, are now able to live at a much more decent standard of living as a result of the reform of their economic policies toward more free-market policies, less regulation, less government and the like. There was one person whom they are more indebted to than anybody else for their great improvement in their situation. In my judgment, that person is Milton Friedman."

So much for the criticisms he endured for years of championing 'inhumane' policies and the interests of 'big business' to the detriment of the little guy. As this tireless and courageous freedom fighter once said:

"Freedom means diversity, but also mobility. It enables today's disadvantaged to become tomorrow's privileged, and, in the process, enables everyone, from top to bottom, to enjoy a fuller and richer life."

Friedman's death comes just as a new television series *The Power of Choice: The Life and Ideas of Milton Friedman* is about to be screened by PBS in the United States.

It is to be hoped that it will be picked up locally so that New Zealand viewers can learn more about a great thinker whose ideas have also helped change this country for the better. The task is not finished. As *The Economist* wrote in a lead article, "Those of liberal spirit ... have plenty to thank Mr Friedman for – and sadly, an enormous amount still to do."*

*First published in *The Otago Daily Times* on 1 December 2006.

Flatter taxes still the international trend

There has been a dramatic move to lower and flatter statutory rates of personal income tax in the OECD.

Sweden and the United Kingdom had top rates of 87 and 83 percent respectively in 1975. An extra dollar of income increased the after-tax income of their top taxpayers by just 13 or 17 cents.

The comparable rates in Ireland, Japan and the United States were 77, 75 and 70 percent respectively. At its peak New Zealand's top rate reached 66 percent.

Only Canada and Denmark of 18 OECD countries had a top tax rate below 50 percent in 1975. By 2005 15 of those countries had a top rate of less than 50 percent. The Netherlands had the highest rate of 52 percent. No country had a higher top rate in 2005 than in 1975.

Much lower top rates and less than proportionate reductions in other rates of tax have produced lower and flatter personal income tax scales. The trend is continuing, with Australia being another country to cut its top tax rates this year.

New Zealand requires attractive tax rates to help offset natural disadvantages that it cannot change. It risks falling behind comparable countries unless well-designed tax cuts are implemented and growth in government spending is contained.

The reintroduction of tax concessions for businesses, as foreshadowed in the review of business tax, are not a substitute for such tax cuts. They cost revenue and reduce the scope for cutting marginal rates. Economic distortions occur when preferential tax treatment is applied to a handful of selected activities or industries.

The move toward lower and flatter tax scales in many countries has been driven by a growing body of research, starting in the 1960s, which shows that high marginal rates of tax are economically costly. They discourage investment, saving, employment and other productive activities, and thus impede economic growth.

Some taxpayers may decide that it is not worth working overtime, taking a promotion or investing in further education and training. Beneficiaries may stay on welfare rather than seek paid employment. Others may simply avoid or evade taxes, for instance by doing 'cash jobs.'

Wealthy individuals may emigrate to more welcoming tax climates and potential immigrants who could strengthen links to offshore markets may choose not to come to New Zealand.

International studies estimate the loss of output arising from a small increase in marginal tax rates to range from around 10 percent to well over 100 percent of the revenue raised.

A flat or flatter income tax would reduce such losses. With a pure flat or proportional income tax a single rate of tax is applied to all income. However, in practice the structure of flat taxes usually consists of an initial level of income which is exempt from tax or subject to a low rate of tax, and a single rate of tax on additional income.

Undistributed company income, trustee income and the earnings of superannuation funds are currently subject to flat rates of tax.

The two-rate tax scale (18 percent on income up to $29,500 and 33 percent on any additional income) proposed by the McLeod Tax Review in 2001 would be a step toward a flat tax.

A flat tax would foster productive activities by reducing the rates of tax that inflict the most harm on the economy. It would also help to reduce the complexity of the tax system. For instance, income earned through companies and superannuation funds could be taxed at the appropriate rate in the hands of those entities. There would be no need to tax individuals on dividends paid by companies resident in New Zealand.

There are also strong arguments on grounds of fairness for a broadly proportional tax scale rather than a steeply graduated one. A person who earns $100,000, five times as much as a person who earns $20,000, would pay five times as much tax.

The Labour Party has adopted essentially a flat tax formula – a 5 percent levy – on its members of parliament to pay for the pledge card. Its decision should not be a surprise. Proportionality is applied in many voluntary situations, for example in dividing profits among partners in proportion to the capital contributed. Most people see that as fair. Why should tax be any different?

A reduction in the top tax rate benefits people on high incomes initially, and may even widen after-tax income disparities in a static sense. But it does not only benefit well-off people. Lower marginal tax rates boost overall economic growth, people move from lower to higher incomes as they gain skills and experience, and strong growth does more for the poor over time than even the most aggressive income redistribution policy.

A flat tax does not prevent the government from engaging in income redistribution. As the McLeod Review observed, most redistribution occurs through government spending.

The International Monetary Fund recently published a paper which was quite critical of certain countries that adopted flat taxes contrary to its advice.

It reviewed the experience of the 8 Eastern European countries that implemented a flat tax between 1994 and 2005. Half of the tax reforms examined

had been in place for just two years. It is impossible to draw firm conclusions based on such limited experience, as the paper notes.

Nevertheless the authors highlight the gap between the claims apparently made by some advocates of flat taxes and experience to date. They rightly point out that some claims were extreme, noting that "there is no sign of Laffer-type behavioral responses generating revenue increases" from tax cuts.

Most respected economists accept that income tax reductions are not usually self-financing over the medium term, let alone the source of higher revenue. But neither is it true that the revenue costs are as large as the effects measured on a static basis. US research suggests that perhaps 40 percent of the initial reduction in revenue might be recouped over the medium term as people and firms respond to the incentives flowing from well-designed tax cuts.

Flat taxes are not new, and are not confined to the former Soviet Union countries. New Zealand's initial income tax – at 6 pence in the pound (2.5 percent) up to £1000 and a shilling on additional income – was close to a flat rate. Hong Kong has had more or less a flat tax for over 50 years.

The IMF may be right to question whether some of the adopters of flat taxes will stick with them. But any departures are likely to be for political, not economic, reasons. So-called progressive taxation – more than proportional taxation on those on higher incomes – is an idea embraced by Karl Marx that has held powerful sway.

But just as other Marxist economic ideas have faded, the trend in tax rates in the last 30 years has been in the opposite direction. A flat income tax rate – like a flat GST – is an idea whose time may yet come.*

*First published in *The Independent Financial Review* on 29 November 2006.

How big is the problem of monopoly?

The economic issue of monopoly often arouses popular passions, and political reactions to them. Are these justified?

In economic theory, monopoly is a potential problem. The 'economic' case against monopoly is that it reduces aggregate economic welfare (as opposed to simply transferring wealth from consumers to producers). When the monopolist raises prices above 'competitive' levels, customers reduce their purchases, less is produced, and society's income is lowered.

How serious is the economic problem of monopoly?

A monopoly arises when a firm is the sole seller of a product without close substitutes. These conditions are quite stringent.

In the absence of barriers to entry into a market, most firms cannot raise prices by much and for long without attracting competitors.

Similarly, many goods are substitutable for one another. Ultimately what we don't spend on something can be spent on something else.

Even a genuine monopolist faces a limit on pricing: if it raises prices too far it will lose customers and profits.

The lure of temporary 'monopoly' positions – an ability to make high profits from entrepreneurial endeavours – is part of what makes the economic world go round.

Last year George Mason University economist Tyler Cowen gave a talk to the Law and Economics Association of New Zealand in which he praised this process.

His three favourite monopolies of the last 10 years were eBay, Amazon and Google. Strictly speaking, they may not be monopolies but they are certainly dominant firms, and they have improved the lives of millions worldwide. Does anyone resent the success of TradeMe, no matter how much money it has made? And will these firms be around in 10 years' time, as others rise to eclipse them?

Whether monopoly is a problem is best seen as a difficult empirical issue, not a theoretical one. There was reason to be concerned about monopoly in the 'old' New Zealand, when many firms enjoyed privileges such as import licences or export monopolies (for example, the Dairy Board).

In today's open economy, most of those privileges have disappeared. Exceptions that should worry us are statutory monopolies such as ACC and Pharmac, and the dominant public health and education systems.

Empirical evidence that monopoly in open markets is a major economic problem is hard to find. Countries like the United States and New Zealand grew to become among the wealthiest in the world before they introduced anti-monopoly regulation (apart from the common law). Hong Kong and Singapore have little in the way of antitrust laws.

A cardinal rule of public policy is that is it not enough to identify a problem; the key issue is whether government intervention can improve matters.

Antitrust (competition) policy that uses the textbook standard of 'perfect competition' and 'competitive prices' is fraught with difficulty.

We can see this easily by observing that it frowns equally on 'monopoly pricing' (prices set above 'competitive' levels), 'predatory pricing' (prices set below competitive levels) and collusion (equal pricing).

None of these problems is straightforward. Even 'plain vanilla' cartels, such as union-based collective wage bargaining in an open labour market, may make economic sense (although there is no reason why the labour market should be excluded from the Commerce Act).

None of this is to argue that we should not have a Commerce Act and a Commerce Commission. However, there are serious risks that regulation in this area can do more harm than good, particularly in deterring investment and entrepreneurship.

In his well-known textbook, Greg Mankiw, a former member of the US Council of Economic Advisors, summarised current economic thinking by saying, "In the end, monopoly power is a matter of degree. It is true that many firms have some monopoly power. It is also true that their monopoly power is usually quite limited. In these cases, we will not go far wrong assuming that firms operate in competitive markets, even if that is not precisely the case."

It is ironic that at a time when New Zealand's markets have never been more open, and when globalisation is constraining the pricing power of firms worldwide, we are seeing more, not less, activist behaviour by the Commission and the regulators of the electricity and telecommunication industries.

Today significant problems of market power seem likely to be confined largely to statutory monopolies and parts of the utility sector. The risks of 'political failure' arising from the imperfections of real political and bureaucratic processes must be weighed against problems of 'market failure.' We are at serious risk of overkill.*

*First published in *The Dominion Post* on 27 November 2006.

Funding political parties: not ordinary government business

The funding of political parties is an important democratic issue. It was one of nine matters addressed in the 1986 report of the Royal Commission on the Electoral System. We can learn from subsequent developments and research.

There has been much public disquiet over the unlawful use of taxpayers' money to fund election spending in 2005. Cabinet is apparently to receive a report before Christmas on options for changing funding rules. Greater restrictions on private support and more taxpayer funding may be proposed.

The Royal Commission's report identified the conflicting considerations. It considered that parties should be required to get the "bulk of their financial needs from their own supporters." On the other hand, it was also concerned that private interests should not have undue influence over political parties. It favoured banning large anonymous donations and third-party endorsements but did not favour capping identified donations. It also recommended that taxpayer funding be tilted against the governing party in order to promote political competition.

Currently, anonymous donations are permitted (as long as the recipient party does not know the source). There is no cap on identified private donations but disclosure is required above $10,000. The Electoral Office has reported that nine political parties obtained $3.2 million in private donations (anonymous and identified) of at least $10,000 during the 2005 election year. National and Labour accounted for $2.8 million of this total. This left only $358,000 in such donations to the remaining seven parties, a significant proportion of which came from the salaries of sitting MPs.

The concern that private donors might obtain improper influence is valid in principle and there is a case for safeguards against it. In practice, however, there is not a lot of empirical evidence that it is a major issue in the New Zealand context. Private donors represent diverse interests. Some are partisan, such as the unions, and others are relatively non-partisan (companies tend to spread their donations). Contrary to some claims, the Business Roundtable has never given money to any political party.

It is also not clear that money buys necessarily votes or political favours. Some think that the Exclusive Brethren's campaign actually damaged National's chances in the last election. Unlike in the United States, business at large in New Zealand does not seek government favours in the form of protection, subsidies and tax breaks (although corporate welfare has been coming back).

Some US research supports the Royal Commission's view that private funding enhances political competition and democratic participation. It also forces

political parties to connect with their grass roots supporters for funding and volunteer labour.

In short, private funding and advocacy do not appear to be serious problems under current rules. For the same reasons that we jealously guard the right to a secret ballot, any proposal to force disclosure above amounts as low as, say, $250 would seem to be an unjustifiable infringement of privacy.

There are other considerations. Can it seriously be suggested that our politicians can be 'bought' for such an amount? How would equivalent contributions like in-kind support (such as free services or voluntary labour) be effectively regulated? Tighter restrictions on advocacy would raise issues concerning the right to free speech.

The current $10,000 disclosure limit may be a reasonable compromise between the case for transparency and the need to avoid intrusive regulation and costly administration.

In contrast, there are more grounds for concern about the growth of state funding since the Royal Commission reported. Taxpayer-funded resources and services of more than $60 million a year are provided to parliamentarians. Labour's pledge card was state-funded, and last year saw the Working for Families package promoted with a $15 million budget.

Researchers have pointed to the link between the decline in political party membership and the rise of state financing. More state funding would further crowd out private support.

The Royal Commission stressed the importance for a democracy of the contest between an incumbent government and a credible opposition. The great twentieth century philosopher, Karl Popper, observed that what distinguishes a democracy from tyranny is the ability of the electorate to dismiss a government that it no longer supports. Power has already shifted from voters to parties and parliamentarians under MMP. More state funding would tend to protect incumbents and entrench party control.

These considerations suggest the major problem New Zealand faces is the departure from the Royal Commission's principle that parties should obtain most of their resources from their supporters, not the state. Limiting the extent and abuse of taxpayer funding should be the key focus of any reform.

Moreover, political party funding is too important an issue to be treated like ordinary government business. There is a strong case for an independent, Royal Commission-like, process for considering changes to current arrangements.*

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*First published in *The Otago Daily Times* on 17 November 2006.

Are good institutions and policies enough?

Last week a report from the New Zealand Institute for Economic Research reminded us that Australians now earn over 30% more than New Zealanders, on average. Gross domestic product per capita in 2004 was NZ$48,000 for Australia and $36,400 for New Zealand. Life expectancy is higher in Australia and infant mortality rates lower. New Zealand is ahead on some other measures of quality of life.

Migration statistics suggest that the balance currently favours Australia. In the last two years, the net loss of people to Australia on a permanent and long-term basis has been 40,000, and on a rising trend.

The NZIER forecasts that the per capita income gap will widen, at least through to 2010. Australia is much more competitive than New Zealand on the World Economic Forum's rankings. It attracts more foreign direct investment per dollar of GDP, invests a greater proportion of GDP, supplies greater capital per worker and gets much more productivity per worker.

So what should the government be doing about this large and widening gap?

The NZIER stresses the importance of free(r) trade and a better regulatory environment for attracting investment. It calls for a return to the light-handed regulation of the 1990s in key infrastructure industries. It considers the Resource Management Act an obstacle to investment and expresses concern about the current regulatory uncertainties surrounding carbon emissions. It argues for an end to government handouts for businesses in the form of 'picking winners.'

A similar prescription comes from the OECD, which regularly reviews New Zealand's economic performance and outlook. In a 2006 assessment it emphasised the need to strengthen incentives to move from welfare to work, reduce barriers to foreign ownership, improve educational outcomes for underachieving groups, reduce restrictive and costly labour market regulation, and address infrastructure bottlenecks, especially in transport and energy.

The Business Roundtable is in the same camp as the NZIER and the OECD. Our major additional recommendation would be for measures to eliminate wasteful or unjustified government spending. New Zealand will not grow fast with total government spending (central plus local) now at 42% of GDP, well above the comparable figure of 35% in Australia. If government spending grew more slowly than GDP, New Zealand could more easily move to lower, flatter taxes, as recommended by the 2001 McLeod tax review. This would reduce the army of tax accountants, lawyers and bureaucrats and facilitate investment.

All these approaches are orthodox and consistent with the large body of economic research that finds that sound institutions and good public policies

are more highly correlated with high levels of prosperity than any other factor, such as an economy's size and location or its endowment of natural resources.

The International Monetary Fund's *World Economic Outlook* 2003 found that three-quarters of the variation in average income per capita around the world could be explained by differences in institutional quality. Specifically, countries that changed their governments without disruption, limited the power of executive government, respected the rule of law in person and property, and enjoyed low regulatory burdens and an efficient public sector, were likely to be prosperous.

Such findings have led the Business Roundtable to suggest extensions to the key institutional changes of the last 20 years – the Reserve Bank Act, the Fiscal Responsibility Act (now included in the Public Finance Act) and the Employment Contracts Act. We have argued for a Regulatory Responsibility Act and a Taxpayer Bill of Rights, and for including property rights in the New Zealand Bill of Rights Act.

It is puzzling to hear assertions that while good institutions and sound policies are necessary, they 'aren't enough.'

This is a bit like telling Tiger Woods that to perform with as much skill and consistency as he can achieve is 'not enough.' True, on the day, it might not be enough because someone else might do better, but this can't conceivably be an argument for doing something differently – like allowing his concentration to waver, or deliberately throwing in a bad shot.

Yet such ideas as introducing compulsory savings for households, tax incentives for exports and R&D, and business subsidies would have just that result – they would reduce the quality of institutions and policies and damage economic performance.

Even if such prescriptions were positive rather than harmful, they could not be material, let alone 'transformational' for economic growth. Their impact would be far less than, say, allowing the government spending ratio to fall over time to 30% of GDP or below, reducing income tax rates to a maximum of 25%, getting central and local governments out of running businesses, giving the private sector a greater role in infrastructure, and reforming regulation.

New Zealand would do far better to follow the advice of the NZIER and the OECD and to continue and extend the orthodox policies that have produced today's better economy.*

*First published in *The Otago Daily Times* on 3 November 2006.

Contest of environmental policy ideas welcome

A fortnight ago, the National Party released a discussion paper on the environment. It is a welcome initiative. There is great scope for better environmental policies in New Zealand.

Green Party spokesman Nandor Tanczos issued a somewhat patronising statement in response, saying National has "a lot of catching up to do." Yet the Greens have no monopoly on good environmental policy.

For a start, they are behind environmentalists in many other countries who recognise that economic growth and environmental improvement usually go hand in hand. Higher incomes and better technology mean greater resources to devote to environmental protection.

Greens elsewhere are abandoning heavily interventionist approaches to environmental problems in favour of more reliance on market mechanisms. Many have dropped earlier anti-car attitudes that still dominate Green Party thinking in New Zealand.

Greens here have been on the wrong side of many environmental debates, or missing in action.

For example, they were not behind the establishment of the market-based ITQ system for fisheries management, although they now promote it internationally.

They have not been notable defenders of property rights, which are the key to much environmental management. They supported the government in closing down Timberlands on the West Coast, a lose-lose outcome on both economic and environmental grounds.

They have resisted the 'proceed with caution' approach to GM, a technology that offers many environmental benefits.

National's general approach is more enlightened, although it has weaknesses. Mr Tanczos may have a point when he says it is light on farming issues such as water contamination and methane emissions. Studies have found that reducing emissions from agriculture is one of the lower-cost strategies New Zealand could adopt if action were warranted.

On climate change, National may be at risk of repeating its 1990s mistake of being over-enthusiastic about signing up to Kyoto. Major players such as the United States, China and India are unlikely to take drastic action against emissions any time soon.

National favours an approach to curbing omissions based on a tradable permits regime, starting with electricity generation. But it is wrong to think such a regime has obvious advantages over an approach based on carbon taxes (which National opposed), coupled with subsidies for sinks.

There is no sign that National has carried out any analysis of the costs and benefits of such an approach. A rough calculation suggests that to have the same overall impact on emissions as a broad-based carbon tax in the range previously contemplated by the government, a tradable permits regime for electricity generation would require at least a doubling or even trebling of electricity prices. The benefits of such a regime, in terms of reduced global emissions, would be close to zero.

In this situation it seems unlikely that the proposal would be politically sustainable; it would certainly be very damaging economically.

On the Resource Management Act, National went into the last election promoting a number of specific changes to be followed by a fundamental review, but the review element seems to have disappeared. This is unfortunate. Among other things, tinkering with the RMA won't solve the problem of the hopelessly fuzzy concepts which are at its heart, such as sustainable management, intrinsic values, Treaty principles, kaitiakitanga and even the definition of the environment, as National's paper recognises in part.

In discussing public access to private land, National sensibly argues that "compensation to landowners should be available where property rights are significantly affected." But this principle should apply across the board, including to the RMA, for both economic and environmental reasons.

The paper advocates a bolder approach to water allocation based on tradable rights than is currently being pursued. This has merit. There is also much to be said for commercial operation and pricing of water supply, something the Greens resist. Metering and other measures have reduced water consumption in New York today to below 1979 levels, despite population growth of over a million in the city.

There are other good ideas in the paper. The criticism of 'smart growth' policies that restrict land supply and reduce housing affordability is amply justified. So too is the idea of charging non-residents for fishing licences, but why not for access to certain national parks also?

National proposes replacing the Ministry for the Environment by a Ministry for Sustainable Development. But 'sustainability' is a weasel word that no one can define. Why not focus simply on good environmental policy with a ministry of that name?

Nevertheless, the general non-socialist approach to environmental management, based on property rights, incentives, prices and market mechanisms, that runs through National's document has much to commend it.

Socialist environmentalism, based on central planning, regulation and collective ownership, leading to the tragedy of the commons, has been as

disastrous as socialist economics. The Greens would do well to catch up with National's thinking and move in new directions.*

*First published in *The Otago Daily Times* on 20 October 2006.

Tax cuts now on the agenda

Last week it was revealed that the 2005/06 budget surplus (following some accounting changes) was $11.5 billion. That equates to around $8,000 per household.

Such a level of over-taxing is indefensible. Tax reductions are now a virtual certainty.

The government's recognition of this reality is welcome. The Treasury's post-election briefing in 2005 emphasised the role of lower taxes, particularly lower marginal tax rates on personal and company income, in promoting economic growth.

It said "The potential growth benefits from an improved tax system suggest to us that the incoming government should seek to pursue this policy within the shortest possible timeframe."

Finance minister Michael Cullen has made some valid points in the tax debate.

He has pointed out that the surpluses are historical, and can quickly fall in an economic downturn.

He has stressed the importance of maintaining a robust fiscal position to underpin New Zealand's credit rating. Essentially this requires maintaining budget balance over the economic cycle.

Prime minister Helen Clark has noted that National's tax thinking seems to waver according to forecast surpluses, and that leader Don Brash's recent position that there may be less room for tax cuts could change again with the revised numbers.

Other views are less persuasive.

Some have argued that the surplus should all be applied to higher operating spending, for example on health and education.

But government spending has increased steeply in recent years to around 42 percent of GDP, including local government. This is squeezing the productive sector of the economy, putting pressure on monetary policy and the balance of payments, and harming economic growth.

In its fiscal planning, the government is allowing around $2 billion a year for new spending or tax reductions. There is ample scope for both.

The need for capital expenditure on infrastructure is not a show-stopper either.

Many infrastructure industries, such as telecommunications, ports, airports and gas, are wholly or partly in the private sector. New investment can be financed out of debt and equity as well as current revenues. The same goes for the electricity SOEs.

In the case of roading and water, Transit and councils have borrowing capacity and there is also scope for private sector involvement.

So less use of current revenue for capital spending would create additional scope for tax reductions, not to mention the winding up of the Cullen Fund.

Concerns about the inflationary impact of tax cuts are overstated. The United States and Australia are experiencing lower inflation than New Zealand, despite significant tax reductions.

From a short-term perspective, tax cuts put less pressure on monetary policy than expenditure increases of the same magnitude, as part of them is saved.

They also reduce wage and other cost pressures on firms. It is extraordinary to hear New Zealand unions opposing tax reductions for workers; Australian unions (and the Australian Labor Party) have supported tax reductions, including to top rates. Rhetoric about "tax cuts for the rich" has been largely absent in Australia.

More fundamentally, monetary policy, not fiscal policy, is what determines inflation over the medium term.

The debate should now focus on the form of tax reductions and the path of government spending needed for them to be sustainable.

The McLeod Tax Review's advocacy of a lower, flatter and simpler tax scale, with an alignment between top personal, company and other rates, should be heeded.

It is widely supported by business organisations and tax professionals.

To their dismay, the government has instead reintroduced an ad hoc tax concession for savings and is talking about concessions for R & D and exports in the context of the business tax review.

Business at large does not want to go back to a tax scale riddled with special concessions. The government seems to be turning a deaf ear.

Given firm control of government spending, an income tax system with top rates of 25% or less within a few years would be within New Zealand's reach.

This would put us nearer the league of Singapore and Hong Kong (where top rates are 20% or less) and greatly boost New Zealand's attractiveness and economic performance.

Government spending, not the size of budget surpluses, should be the starting point for tax policy planning. National's plans for tax cuts at the last election were largely based on surplus reductions.

There is a strong case for fiscal rules limiting annual spending increases to the rate of population growth plus inflation, unless taxpayers supported higher increases in referenda.

With tax reductions now on the agenda, we need a broader debate around spending limitations, the scope for greater private sector involvement

in infrastructure and other services, and the case for lower and flatter taxes in the interests of competitiveness and growth.*

*First published in *The Dominion Post* on 16 October 2006.

School choice lifts underachieving students

Among those returning to school for their final term next week, we know that Maori and Pacific Island students will be heavily over-represented in the groups who leave school early and with little or no formal attainment.

Last year nearly half of Maori and 37 percent of Pacific Island school leavers did not reach a Level 1 qualification. Only 59 percent of Maori boys were still at school at 16, compared with 90 percent of non-Maori boys. Far too many students in low socioeconomic groups of all ethnicities will also fail and be failed by our school system.

While it delivers a good education to many, there is a large gap, by OECD standards, between children at the bottom and at the middle of our achievement range, and we have a long 'tail' of underachievers.

There are many complex factors behind these statistics, but we know that some schools get better results from these groups of students than others. Schools matter, regardless of socioeconomic backgrounds. We also know that many parents, given a choice, vote with their feet and move their children from failing schools to more successful ones.

One such failing school closing this year is decile 1 Sunset Junior High School in Fordlands, the Rotorua suburb made famous by Alan Duff's novel *Once Were Warriors*. Parents dissatisfied with the school's offerings have progressively shifted their children to other local, more successful intermediate schools, and the roll has fallen from a peak of 700 to 70.

The freedom to open, expand and close in response to increased or reduced demand is one of the three essential design elements of successful school choice policies outlined by Harvard University Professor Caroline Hoxby, in a report released last month by the Education Forum and the New Zealand Association of Economists.

The two other critical factors Hoxby identifies in *School Choice: The Three Essential Elements and Several Policy Options* (www.educationforum.org.nz) are: funding following the student, so that all schools (public, private, for-profit, non-profit) are on the same footing; and independent management, so that schools are free to innovate in areas such as teaching practices, teacher pay, and school organisation.

The quality of New Zealand's school choice policies has been patchy, to say the least. They include among other things the *Tomorrow's Schools* initiatives of the 1980s which increased school autonomy and parental involvement; some up and down changes to funding of independent schools; and the abolition in 1991 of school zoning, now partially re-imposed.

Interestingly, research (from the 1990s Smithfield Project) tells us Maori and Pacific Island families made the greatest use of choice when zoning was removed. The proportion of Maori attending 'non-local' schools rose from 21 percent in 1990 to 39 percent in 1995 and for Pacific Island students from 18 percent to 38 percent.

Another New Zealand initiative that perhaps came closest to including the three critical elements identified by Hoxby was the Targeted Individual Entitlement (TIE) scheme, a small scale voucher scheme introduced in 1996, which provided government funding for children from low income families (earning under $25,000 per year) to attend an independent school of their choice. The scheme, which was oversubscribed and seen as highly successful by parents, students and teachers, was abolished in 2000.

Further evidence of the gains that can be made in student achievement through sound choice policies can be found in Hoxby's report. It draws on, amongst other work, a study of the impact of Chicago's charter schools on student achievement.

These are public schools that are independently managed, fee-based (each student brings 75 percent of what a regular school receives), participate in state-wide testing, and can admit students from anywhere in Chicago. They are free to innovate, can apply to expand if they are oversubscribed, hire and reward teachers as they see fit, and can extend the school day and year.

The schools in Hoxby's study were in inner-city neighbourhoods serving disadvantaged children. Students in the study and an almost identical control group were 74 percent Black, 22 percent Hispanic, and 81 percent poor.

After two years the students in charter schools had mathematics and reading achievement about 6 percentile points higher than the students who continued in regular schools. To put it in context, that's equivalent to more than half the difference in achievement between very disadvantaged students in the United States and typical US students.

Debate about the merits of choice and competition in education will no doubt continue. Those who are confused about the claims and counter-claims should ponder two basic questions. When have we ever seen a quasi state monopoly perform as well as a market with competing suppliers? And, as a moral issue, why should parents not have the freedom to make their own decisions about their children's schooling, regardless of what educrats might think is best for them?*

*First published in *The Otago Daily Times* on 6 October 2006.

Question marks over Telecom regulation

Parliament's Finance and Expenditure Committee has been hearing submissions on the bill that, among other things, will force Telecom to allow competitors access to its network on mandated terms.

This is a major regulatory intervention at a time when the business sector has been complaining about over-regulation and when the government has set up an inquiry into regulatory frameworks.

The push for regulation has come mainly from Telecom's competitors and user groups. Representative business organisations, including the Business Roundtable, Business New Zealand and Federated Farmers, have argued that the government has not adequately justified such a draconian step.

One analysis that appears to have had impact on the select committee is a 167-page submission by academic Bronwyn Howell of Victoria University. She rebuts claims that New Zealand is seriously lagging in broadband services, that this is harming economic performance, and that unbundling increases broadband uptake. It is a far more cogent analysis than the government has presented, and concludes that the case for further regulation is "not proven."

It should be explained that the argument is not about whether Telecom should be opened up to competition. Deregulation of the telecommunications market accompanied corporatisation and privatisation. The government was concerned not to give Telecom any monopoly privileges. Many new entrants, ranging from Vodafone and TelstraClear to niche operators, have come into the market.

Rather, the argument is about whether normal competition should continue, with operators investing in new networks and facilities, or whether forced competition should be introduced, allowing access to Telecom's network on other than freely negotiated commercial terms.

This has been called "parasitical competition" or "infrastructure socialism." It is like forcing Karen Walker to stock Trelise Cooper's lines in her shops. This may have short-term benefits for consumers but how many new outlets will Karen Walker open on that basis? The risk is that new investment that may deliver large benefits to telecommunications users will be slowed down.

In its submission, the Business Roundtable made two key points.

First, no cost benefit analysis was offered in the regulatory impact statement accompanying the bill. This is inexcusable. The Telecommunications Commissioner, Douglas Webb, presented such an analysis in his 2003 report on unbundling, which concluded that it was not justified.

It's easy to generate short-term benefits to consumers by regulatory actions. The government could pass a law requiring airfares to be cut by 50%. This would benefit travellers for a time but would have major costs in the form of fewer air

services and losses to investors. The relevant policy issue is whether the benefits exceed the costs.

We made a rough cost benefit calculation in our submission. The Telecommunications Commissioner estimated the benefits to consumers of unbundling to be under $100 million over a five year period. The losses to Telecom investors look like being in the order of $3–4 billion. Even if the consumer gains are an under-estimate, and allowing for other relevant factors, it is very difficult to see how the numbers stack up in favour of regulation. We said officials should be asked to do the job properly before parliament acts.

Secondly, we said that if a sound case for regulation in the public interest could be made, the costs should fall on the public at large, not just investors in Telecom. The issue of compensation should be addressed, just as it is when the government compulsorily acquires land under the Public Works Act. Michael Cullen has argued that other countries did not compensate investors for losses when local loops were unbundled, and that Telecom is merely being deprived of monopoly profits. However, two wrongs do not make a right, and the bill does not accuse Telecom of acting unlawfully or abusing a monopoly position.

There are other disturbing developments in network industry regulation in New Zealand. The government overrode the advice of its arm's length Telecommunications Commissioner, Douglas Webb, on the grounds that it didn't like it. Mr Webb informed the select committee that he has not changed his opinion on unbundling.

This month the government has sacked electricity industry regulator Roy Hemmingway for similar reasons. Interestingly, in a former role in the United States, Mr Hemmingway oversaw a process of telecommunications unbundling. It would be useful to have the benefit of his views on experience with it (the United States is moving away from unbundling).

We now have huge uncertainty in two vital infrastructure industries, telecommunications and electricity. The lack of due process, the prospects of ongoing regulatory debates and litigation, and the bad signals to domestic and foreign investors bode ill for the future.

With the government itself expressing concerns about over-regulation, the best thing parliament could do on the telecommunications bill might be to follow the medical axiom "first do no harm" and require it to be subjected to more competent and dispassionate scrutiny.*

*First published in *The Otago Daily Times* on 22 September 2006.

Local government: new framework needed

Auckland City Council funding séance courses and toll calls to the Congo; Hamilton losing $200,000 supporting Warriors matches against the Eels; South Waikato investing $600,000 in two broadband companies that failed; New Plymouth investing in high-risk ventures in China and talking about running a café; Wellington blowing nearly a quarter of a million dollars on Tiger Woods; sock and plastic factory fiascos on the West Coast; Christchurch setting up a garden show in competition with a private operator; Invercargill subsidising a Lotto shop; and uneconomic stadiums in Auckland and elsewhere – the list of recent local government follies reads like an unrolling scroll.

And if such decisions are being made in absurd cases, how many more bad ones are being made across-the-board, generating the mushrooming rate increases that are now causing a public outcry?

The problem doesn't end with spending and rating. Councils have equity to the value of over $60 billion, or $14,500 per capita, in assets such as ports, as the attached table shows. Rates of return on port assets are poor in many cases, indicating that capital could be put to better use and that economic growth is being sacrificed, and council ownership is impeding port rationalisation.

Too many councils have strayed far beyond their proper role. A June 2006 survey commissioned by the Department of Internal Affairs found that 39% of respondents think councils waste ratepayers' money compared with 32% who think they do not. Meanwhile core services are being neglected, as we saw recently when Kelly Tarlton's was flooded with sewage.

There are exceptions, of course – Tauranga is one good model. Typically smaller councils are most focused on the basics and local democracy is stronger. In larger centres it is much weaker and calls into question ideas such as a super-city for Auckland. In a poll two years ago nearly 90 percent of Aucklanders could not name one member of the Auckland Regional Council.

The business sector, which nationally pays around half of all rates, is largely disenfranchised (hence the unjustified differential rates burden lumped on it by many councils). This year the Local Government Forum, representing a large cross-section of businesses, gave up making submissions on council plans.

Councils have been encouraged to become much more expansionary by the Local Government Act 2002. Rates have grown faster than the CPI, as the attached chart shows, and rates revenue nationwide is projected to grow by 7–8% over the next three years, much faster than projected economic growth. The government's idea that councils would be constrained by the requirement for long-term plans and consultation processes was naïve. The plans have proved to be costly and unintelligible exercises in many cases. A major consultation

meeting in May called by the mayor of Wellington in the council chamber had an attendance of four.

We need government at the local level essentially to facilitate the provision of public goods and services and some infrastructure, and to administer necessary local regulation. We should not have councils providing private goods and services (generally speaking, those that can be directly charged for), which should be left to the private sector. Central government should be largely responsible for necessary social services, such as housing.

Much of the current debate is wrongly focused. The government's basic error was to give councils an expansionary mandate; criticisms that rates have gone up because costs have been shifted by central government are weaker. As minister of local government Mark Burton has noted, out of 67 pieces of legislation 28 were specifically requested by local government, 26 do not appear to impose costs, and other measures (some of which are dubious) have impacted on council fees, not rates.

Similarly the government's proposed inquiry into local government risks missing the target. It appears to be focused on funding issues and alternatives to rating, rather than on what councils should be doing and on their spending.

This would involve looking at what activities should be put into region-wide governance structures (for example water and roading), which could be shifted to the private sector (such as ports and airports), and which should remain the direct business of councils.

Constitutionally, local government is a creature of central government and central government needs to give it a better framework, one that puts more power in the hands of ratepayers.

A framework with two key features would have considerable merit.

First, a new local government act would list the core public goods functions that councils could undertake. If they wished to go beyond them, they would need to get the support of, say, two thirds of their ratepayers in a poll. Decisions on such things as stadiums would be in the hands of ratepayers.

Secondly, annual increases in council spending and rating would be limited to the rate of inflation plus population growth, unless councils went to ratepayers with a case for higher increases. This would not disadvantage councils with requirements for lumpy expenditures: if a case could be made, why should the verdict of, say, two thirds of ratepayers not be trusted? Similar mechanisms in US states have seen voters both approve and disapprove proposals to relax spending limits.

Given such constraints, property rating in general is an adequate tax base for local government. It could be improved: for example it should be extended to most Crown properties and Maori land, and higher differential rating of businesses should be scrapped. However, the horse should be put before the cart: unless the

focus is placed first on functions and spending, inquiries into rating are likely to bring little relief to aggrieved ratepayers.*

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*First published in *The Independent Financial Review* on 13 September 2006.

The deadweight costs of taxation

The 2001 McLeod Tax Review pointed out that taxes can never be raised costlessly. It noted that apart from compliance and administrative costs, taxes impose 'economic costs' because they induce individuals to make decisions that they would not have made in their absence. These costs (referred to as 'excess burden' or 'deadweight costs') can be regarded as the difference between the amount individuals would be willing to pay to avoid having a tax imposed and the net amount of tax collected, after allowing for costs of compliance and administration.

Deadweight costs can be illustrated in the following way.

Suppose Jane cleans Mary's house each week. To make the job worthwhile Jane wants at least $80. Mary would be prepared to pay up to $120 for a clean house. They agree to a rate of $100, with each gaining $20 from the deal – a total economic surplus of $40.

Now suppose the government slaps a tax of $50 on cleaning services. There is now no price that Mary can pay Jane to make the deal work. The most it would be worth her while to offer would be $120, but that would leave Jane with only $70 in the hand, which she is not prepared to accept. Conversely, for Jane to get $80 Mary would have to pay her $130, which is more than the value she puts on a clean house.

So the arrangement falls through – Jane goes without the income and Mary lives in a dirtier house. The tax has made them worse off by a total of $40 – the previous surplus – and the government gets no tax revenue.

These effects of taxes on behaviour are pervasive. Typically if you tax something you get less of it. Thus taxes on alcohol and tobacco are aimed a reducing drinking and smoking.

The same goes for income tax. Finance minister Michael Cullen has said that if he had to pay less tax he would not work more. However, income taxes affect many things other than the number of hours worked, such as whether to train or take a promotion, whether a second member of a household takes a job, the timing of retirement, and decisions on whether to consume, save and invest. More income tax means less national income.

Whether deadweight losses are small or large depends on many factors, particularly the size of the tax. Higher rates of tax generate larger losses, and they increase exponentially as taxes rise. This is one of the arguments for a broad-base, low-rate tax system. A 10% tax rate might generate an excess burden of 5 cents (deadweight loss of 5 cents per dollar of revenue raised), which rises to 20 cents when the tax rate is 20% and to $1.25 when the tax rate is 50% (around the effective rate for many Working for Families recipients).

The deadweight cost of taxation has risen in New Zealand with increases in the size of government. A study by Erwin Diewert and Denis Lawrence published by the Business Roundtable in 1994 found that the excess burden arising from labour taxation (primarily taxation on the income of wage earners and the self-employed) had gone up from 5 cents to 18 cents per additional dollar of revenue raised between 1972 and 1992. The marginal excess burden of consumption taxation (mainly GST) increased from about 5 cents to 14 cents.

What this means is that, for it to be justified, a government project financed by increased labour taxation would need to return $1.18 net of collection costs for each dollar spent on it. If it returned only $1, roughly speaking 18 cents of national income would be sacrificed. Put another way, there would be an 18 cent gain to the economy and a $1.18 gain to the private sector (households and firms) from cutting government spending by $1.

These figures are likely to be conservative as the top income tax rate has risen since 1992 and the deadweight cost of taxation of capital income is likely to be higher than for labour and consumption taxation – perhaps as high as 50%. Treasury guidelines provide for a figure of 20% to be applied to the costs of public sector projects funded from taxation to reflect the deadweight loss.

The key insight from all this is that the cost of an additional $1 in taxes and spending is much more than $1. It is likely that many government spending programmes do not yield benefits of $1.18 for each dollar spent. Thus taxes need to be treated like the scarce resource that they are and not used to fund wasteful programmes or services that many people could fund themselves, given lower taxes and higher per capita incomes. Excessive taxation hurts economic growth and people's welfare in general.*

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*First published in *The Otago Daily Times* on 8 September 2006.

It's yesterday's schools once more

While other countries move forward with innovative policies in the education sector, New Zealand continues its rapid slide backward in this important area. The minister of education, Steve Maharey, appeared to put another nail in the Tomorrow's Schools coffin at a recent conference. He indicated a government review of funding would look first at the way schools spend their funding, before looking at how much funding they receive.

What Mr Maharey was reportedly referring to was a review of schools' so-called 'operations funding' – the non-salary component of school funding that boards of trustees control. If the government moves to control 'operations funding' in the same way it controls spending on teachers' salaries, it will see the demise of one if the last remnants of local decision making that underpinned the Tomorrow's Schools reforms.

While New Zealand schools remain nominally 'self-managing,' much of their decision-making authority has been stripped away through the government's decision to abolish bulk-funding of teachers' salaries, the progressive reintroduction of school zoning, the reinstatement of centralised contracts for principals, and other changes.

Unfortunately, the bias against innovative policy reforms is not restricted to education, as we have seen with the demise of privately managed prisons (despite evidence showing they were successful), the renationalisation of ACC and a ban on privatisation. (The World Bank recently noted that "privatisation is now so widespread that it is hard to find countries not using the approach: North Korea, Cuba and perhaps Myanmar make up the shrunken universe of the resistant." It obviously overlooked New Zealand.)

The regressive nature of government policy in education was laid bare last month with the release of an Education Forum report by Norman LaRocque entitled *Contracting for Education Services: A Typology and International Examples* (www.educationforum.org.nz). It is an international survey of contracting arrangements in education, including the private management of public schools, government contracting with private schools to enroll students at public expense, and public–private partnerships (PPPs) for school infrastructure.

While contracting with the private sector for the delivery of ancillary services, such as catering, school transport and cleaning, has been common in the education sector here and overseas, more sophisticated forms of contracting – such as private management of public schools and education infrastructure PPPs – are relatively new.

Governments in countries as diverse as the United States, the Philippines, Colombia, the United Kingdom and Australia are now contracting directly with the private sector for the delivery of teaching or school management.

One of the examples discussed in the Education Forum report is the US model of charter schools. These are secular public schools that operate with freedom from many of the regulations that apply to traditional public schools, including geographic enrolment restrictions and teacher union contracts. The quid pro quo for this additional freedom is accountability for results. Charter schools may be managed by community groups or (increasingly) by a for-profit or not-for-profit school manager. The first charter schools date back only to the early 1990s, yet they have grown to more than 3,400 today, serving around 1 million students. They have broad support across governments of the so-called left and right in the United States.

Other examples include the private management of public schools, whereby governments hire companies such as Edison Schools to run poorly performing public schools. While this idea has been raised on occasion in New Zealand by the National and ACT parties, it has yet to stimulate much debate. This is understandable – it is hard to promote innovative reforms when the government and teacher unions are so firmly set on turning the clock back to the days of central control.

The policy innovations cited in the report are not all small 'pilot' programmes. Many are significant in scale. One such is the Educational Services Contracting programme in the Philippines, with nearly 400,000 students being subsidised by the government to attend private schools. Under the Private Finance Initiative in the United Kingdom – an infrastructure PPP programme – contracts for more than 120 education sector projects had been signed by the end of 2004, with a value of some £3 billion.

Contracting for the delivery of educational services can have many benefits: increasing efficiency, allowing educational institutions to escape much of the over-regulation they face, improving the quality of delivery, making the costs of education transparent, and bringing new skills into the education sector.

Contracting policies must be designed and implemented carefully, and they require new capabilities and a significant mindset change among the public servants who administer them.

These ideas merit further consideration here. If New Zealand is to use its education resources to the best advantage and get the best possible results for students, we would be remiss to ignore the possibilities that contracting can offer as another tool in a well-stocked education policy toolkit.*

*First published in *The Otago Daily Times* on 25 August 2006.

The weak arguments for subsidies for stadiums and events

Stadiums and events involving central and local governments are often controversial. The redevelopment of Carisbrook is a case in point.

Wild claims are often made about the economic benefits of such projects. There has also been a sorry saga of cost overruns.

When the feasibility study for Wellington's Westpac Stadium was done in 1994, the cost was estimated at $62.75 million. By the time it was finished it had risen to $122 million.

Another financial embarrassment was the Waikato Stadium project, which the Hamilton City Council bailed out in 2002 for $5.5 million. And last year it was reported that the Auckland Regional Council was facing potential losses of nearly $1 million after only selling half the corporate seats for Ericsson Stadium's new grandstand.

Similar stories abound abroad. According to a Victorian Tourism Industry Council survey, this year's Commonwealth Games in Melbourne provided only a fleeting boost to the Victorian economy, despite claims by the state government of massive economic benefits. A detailed study found that even the Sydney Olympics had only a modest economic impact. Most of the venues have been little used since the games.

An Auditor-General's report found that Canberra's annual tax-funded V-8 Supercar races, which the Wellington City Council sought to stage last year, generated more costs than benefits.

Various bogus arguments are put forward in support of subsidies for stadiums and events, often by consultants who are paid to provide the answers councils want.

One is that they generate community benefits above and beyond the benefits enjoyed by those who attend events or watch them on television. But such benefits can be captured in many ways such as naming rights, corporate boxes and donations, as well as admission fees and television rights. All or most of the benefits from the stadium or event can be captured or 'internalised' through these means. The Business Roundtable argued that businesses that stood to benefit from a V-8 car race in Wellington should put their hands in their own pockets, not those of ratepayers.

Many studies invoke 'multiplier' arguments associated with attendance at events (for example, spending on accommodation or meals) as additional benefits. These are usually fallacious, because disposable income spent in this way is not spent on goods and services produced by other businesses: there is no overall net

gain. Such expenditure-switching should not be confused with the creation of real economic value.

A further error is to confuse gross spending with value added. The costs of producing goods and services such as food or transport need to be deducted from gross spending to calculate real economic benefits.

There is no evidence that subsidies for stadiums and events increase the economic well-being of cities. A variety of studies have found no correlation with rates of economic growth, employment or rating bases. Many stadiums and events lose money.

These are not arguments against stadiums and events. The point is rather that just because people enjoy them and they produce economic benefits it doesn't mean they should be subsidised. Most activities generate economic benefits and most operate privately without subsidies. Taxes to fund subsidies harm other worthwhile activities. The mere fact that councils are faced with calls to subsidise stadiums and events may suggest that public support for them is broadly lacking. Private investment in stadiums and events is perfectly feasible in many cases: Tauranga's Baypark Speedway Stadium and the annual Gisborne Rhythm 'n Vines festival are examples.

A willingness on the part of councils to subsidise projects is likely to displace private investment. Moreover, private investment in such projects is less costly to the economy. Rates and taxes are costly to raise, not just because of the administration involved but because they distort behaviour and make the economy less productive. The total costs may well be of the order of at least 30–50 cents for each dollar raised. Thus the returns on subsidy-funded projects need to be commensurately higher than those on private investments.

Why then do we see so many cases of subsidies, financial losses and cost overruns in relation to stadiums and events?

The answer is that subsidies often benefit stadium owners, sporting organisations, event sponsors, local politicians and limited groups of fans, rather than the general public. These groups have incentives to publicly campaign for projects and offload the costs on to the larger body of ratepayers. Voters are often kept in the dark and have little say.

I believe councils contemplating subsidies for such projects should publish information about the costs and the implications for rates, and hold a referendum requiring the support of, say, two thirds of ratepayers for the project to proceed.

Direct voting, rather than 'public consultations' that are often dominated by politicians and interest groups, is a much more accurate way of gauging what people are prepared to pay for.*

*First published in *The Otago Daily Times* on 11 August 2006.

Building a culture of philanthropy

There were headlines around the world last month when Warren Buffett, the hugely successful investor, announced that he was giving $31 billion of his wealth to the Bill and Melinda Gates Foundation, roughly doubling its size. This philanthropic initiative was roundly applauded, and rightly so.

It is no accident that it happened in America. Not only is the United States the world's most successful commercial nation; it is also the standout nation for philanthropy.

This is no paradox, as another wealthy American, Steve Forbes, recently explained. "In fact, philanthropy and capitalism are two sides of the same coin. To succeed in business in a free market economy, one must meet the needs and wants of others . . . and take risks. Misers do not found companies like Microsoft."

Although the United States is sometimes described as having an excessively individualistic culture and a deficit of community spirit, generally speaking the opposite is the case. And it is not just a matter of the so-called 'rich.' Many ordinary Americans make a practice of giving a week's income a year to charity and engage in much volunteering.

Philanthropy is not a feature of socialistic countries. Indeed it was an explicit part of the socialist programme to undermine charities as competitors to the state.

Nor is philanthropy about 'giving back.' This is a misleading phrase because it implies that something was taken from others in the first place.

To the contrary, Bill Gates has done far more for ordinary people in the world through the creation of Microsoft's software and operating systems than he will ever do through his foundation. By making firms and economies more productive, it has improved the lives of people almost everywhere.

Why is charity less of a feature of countries like New Zealand? Key reasons are that the state has taken over so many welfare functions and high taxes mean people have less income to give.

As a prominent New Zealand journalist wrote to me, "I cut back my own charitable giving after the government raised the top tax rate to 39 cents because it was explicitly predicated on providing more social services, which was a clear signal less of my contribution was needed or wanted."

Some argue that the tax deduction for charitable donations should be increased to encourage more philanthropy. But it is a common New Zealand flaw to want to give subsidies or tax concessions to something just because it is good.

Such concessions make the tax system more complex, create difficult boundary problems between charitable and non-charitable activities, and cause tax rates to be higher to make up for the lost revenue.

A better approach is simply to cut taxes. Following the Reagan tax cuts in the 1980s there was a striking increase in charitable giving in the United States.

The voluntary sector in New Zealand should join forces with those who are pointing out that the state is doing a poor job in areas such as the provision of social services, where it has over-reached itself.

If it progressively drew back and taxation were reduced, it would allow those on middle-class incomes to take greater responsibility for their own needs, and voluntary organisations would be able to do more to provide the personalised care for people that government bureaucracies, necessarily constrained by rules, cannot do a good job of providing.

Charitable organisations should also publicly recognise and applaud people engaged in philanthropic activity. Too often those who get media attention are the self-promoters, not those who are privately more generous.

If it is run in a hard-headed way, the Gates Foundation may stand a better chance of doing good than many government aid programmes. It is fatuous of people like Sir Bob Geldof to call for more official aid without recognising that much of it has done more harm than good.

What matters most for curing poverty is not transfers of money or new technology (such as miracle drugs) but good government.

Here people like Gates and Buffett, despite their outstanding success in business, will have a whole new trade to learn. They and others like George Soros have had odd ideas on economics and public policy. When Buffett, for example, says "a market system has not worked in terms of poor people," one would think that the rise of China in recent decades had passed him by.

Good government, in the form of sound institutions and policies, is the key to economic growth and poverty alleviation. These cannot be simply transplanted; they must develop indigenous roots.

If I were Gates and Buffett, I would devote a good part of their foundation's resources to supporting the free-market think tanks and university institutes that are pushing for reform of the institutions and policies that are holding back progress in poor countries.*

*First published in *The Otago Daily Times* on 28 July 2006.

Scanning the far horizon: Treasury's fiscal outlook

Last month the Treasury released a report on New Zealand's long-term fiscal position, looking out to around the middle of this century.

This is the first such four-yearly report required under the Public Finance Act 2004. Australia and numerous other countries have attempted similar long-term fiscal assessments.

As predictions these would be heroic enterprises. Much of what will happen in the future is unknowable. The mechanistic projections in Treasury's charts suggest relatively smooth trends. Reality may be quite different, as the economy is impacted by unexpected events and policy changes. This calls attention to the need for prudent planning and economic flexibility.

Nevertheless, the Treasury does a professional job of projecting plausible trends in major spending categories and taxes, based on assumptions about the size and structure of the population and the economy and government policy settings.

Its demographic assumptions are for population ageing with increasing life expectancy and lower fertility rates.

These are largely beneficial trends, and not a crisis. Moreover, attempts to engineer population changes, for example through immigration, would have limited impact.

Interestingly, Treasury implicitly casts doubt on the widespread notion of a marked 'browning' of the New Zealand population in the future. It notes that "convergence between Maori and Pakeha is continuing in many aspects of life." This is likely to include fertility in due course.

The document suggests that with population ageing, spending on New Zealand Superannuation (NZS) and health is likely to rise relative to GDP, particularly from the 2030s. Spending on welfare and education is likely to fall, but not by as much.

So fiscal pressures will increase, but slowly and against a background of a fiscal position which is strong by both historical and international standards.

And Treasury emphasises that the largest single driver of the fiscal position is the policy choices governments make. Even relatively minor changes in such things as the indexation of superannuation benefits can have large cumulative effects.

What may be under-emphasised by the Treasury is the influence of economic performance and productivity on the fiscal choices governments will face and on living standards generally.

Treasury assumes that trend labour productivity growth will be 1.5% a year, which means that real incomes will have more than doubled by mid-century.

This should mean less need for state welfare support by then, just as the much higher average incomes today should mean less need for welfare than when it was expanded in the 1930s.

But such modest labour productivity growth also means per capita income growth in New Zealand is unlikely to be consistent with the government's stated goal of getting New Zealand back into the high income league. Indeed, given that Australia and many other countries are likely to grow faster, New Zealand could fall further in the rankings.

This prompts two final reflections.

First, the report discusses New Zealand largely in isolation from possible developments in the rest of the world, yet these could have very marked implications.

For example, if an increasing income gap between New Zealand and Australia (and other countries) materialised, it is not implausible to suggest that New Zealand could experience a net outflow of population, as Ireland did for many decades. Many developed countries will be seeking skilled and enterprising workers as their populations age.

Secondly, it is perhaps unfortunate in a document aimed at advancing public understanding and debate that Treasury did not say more about the proper role of government.

In respect of the government's role in retirement income, it rightly noted that a greater focus on NZS as a safety net and increases in the eligibility age could go far to reduce future fiscal costs. However, a similar discussion of the government's role in health would raise issues such as the case for greater resort to user charges to discover the value placed on health services, the role of private insurance, and the potential for more efficient provision by the private sector.

It is likely that people will want to spend relatively more on health care as incomes rise, but it doesn't follow that this should all be done by the government.

Debates on issues such as the mediocre growth outlook and the proper role of the government in the funding and provision of services are better held sooner rather than later if New Zealand is to realise its potential.*

*First published in *The Dominion Post* on 12 July 2006.

Roading: still many roadblocks

Last week the government and Transit New Zealand announced the 10 year state highway plan to 2015/16.

Apart from some criticisms from the Greens, it was well received. It reflected the 2006 Budget decision to make good the shortfall in the National Land Transport Programme due to construction cost increases and lower projected petrol tax receipts.

The additional funding mainly came from a special dividend paid to the government by Meridian Energy following its sale of its Australian operations. This was a sensible decision to exit from an activity that the government does not need to be involved in (electricity generation) and apply the proceeds to one it does (roading).

Transit's share of this funding ($425 million over five years) will enable it to reinstate projects and accelerate state highway improvements beyond August 2005 levels.

Also part of the announcement was a five-year funding commitment by the government. This will facilitate better planning by Transit and private sector consulting and construction firms. In the past, funding was allocated on a year-to-year basis with no guarantees for future years.

These developments are positive. Most freight and passenger transport, including buses, depends on roads. The share of the market that can be handled by rail or public passenger transport is small, although there is some potential for expansion.

However, it is not yet time to break out the champagne. The announcement was basically about spending more money. There is much else that needs to be fixed about roading.

Transit has said that the funding injection will lower average benefit cost ratios. In recent years, projects with BCRs of 3:1 and even 4:1 have not received funding.

Assuming the calculations are being done properly, this means that projects that would have yielded favourable returns from a national viewpoint, and thus contributed to economic growth, were not going ahead. Investment should be occurring where benefits equal or exceed costs, ie when BCRs are equal to 1:1 or more.

It is still the case that apparently justified projects (with BCRs of 1:1 or more) will not be funded. This is a concern. The public or the private sector should be funding such projects, and levels of funding should not be dependent on the size of the government's operating surplus.

Worse, Transit may also be funding unprofitable projects, ie ones where costs exceed benefits, which are therefore a poor use of capital and reduce potential living standards.

That this may be happening is evident from an email from a Transit board member to former transport minister Pete Hodgson last year which read:

"We used to roll up once a month, run down the list of projects that were ordered from the highest benefit cost ratio to the lowest, draw a line when we ran out of money, which seemed never to be far down the page, then pick our brains up at the door on the way out. Today, the job is harder, much more interesting, and more subject to eureka moments, even from me, as we explore the limits of our imagination. This transport strategy of yours ain't easy. But I think it matters. And it is a hell of a lot of fun."

Projects with BCRs less than 1:1 should seldom be accepted. Fun is not what the job of spending taxpayers' money prudently is about, and brains should be applied to things like scrutinising project analyses and maximising value for money spent on roads.

Moreover, it seems that the roading programme will still not solve Auckland's traffic problems, and may not even improve congestion by 2015.

Imagine the outcry if other utilities failed to deal with avoidable congestion problems and treated their customers to 'busy signals' on phone lines or routine electricity restrictions on water heating.

Road building will not be economic and lead to reduced congestion if roads are not priced efficiently. Here the Greens have a point – if goods or services are free or underpriced, queues are likely. The solution – not emphasised by the Greens with their exaggerated focus on public transport – is better forms of road pricing (such as electronic tolling) to replace petrol tax and other road user charges where it is economic to implement them.

Unfortunately the Ministry of Transport's recent consultation paper on congestion in Auckland ignored an approach based on standard principles of economic efficiency.

Finally, roading is likely to remain bedevilled by all these problems while it remains under direct political control. Increasingly, roads can be run on lines more akin to those of other utilities. Commercially-structured roading utilities could be expected to make more timely and efficient roading decisions and be less vulnerable to central and local government political pressures.

Road management was heading in that direction with the previous government's *Better Transport Better Roads* proposals. Until we revisit that approach, road users' interests will continue to be short-changed.*

*First published in *The Otago Daily Times* on 7 July 2006.

SOE policy: dumb and now dumber

The government's decision to encourage state-owned enterprises to expand into new areas of business has had a bad reception from commentators.

And rightly so. The government talks about 'evidence-based policy' – making policy on the basis of relevant facts and research. Yet empirical evidence, not ideology, strongly points to the folly of government ownership of commercial enterprises, let alone a policy of diversification.

The decision was taken in the name of 'economic transformation.' This is a meaningless buzzword, but in essence the government is talking about economic growth. Minister Trevor Mallard put the issue in this context: "Economies need to grow. This is the only way that society collectively can generate the output needed to improve services and raise living standards for New Zealanders."

Few issues in economics have been subject to more exhaustive empirical investigation than the relative performance of private and government-owned commercial enterprises in using resources efficiently, generating profits and contributing to economic growth.

Surveys by the OECD and the World Bank reviewing over 50 published empirical studies examining hundreds of privatisations around the world conclude that, on average and over time, private firms out-perform their state-owned counterparts.

The qualifier "on average and over time" is important. Clearly some private firms fail and some SOEs succeed, at least for a time.

Air New Zealand is an example of a privatised company that failed. However, the government had other options than bailing it out. Moreover, even though the board and management have done a creditable job of giving it a chance of survival, the company has been a poor investment from the point of view of taxpayers. The Crown has made a zero return on its investment at a time when the NZX gross index has risen by around 77%. The Air New Zealand case reinforces rather than undermines the case for governments getting out of running businesses.

Because the odds are against successful state enterprise, the government's decision to allow SOEs to expand beyond their core business, in addition to its unique (among OECD countries) stance against privatisation and its renationalisation initiatives (such as accident insurance, Kiwibank, Air New Zealand and the rail track), must be bad for growth.

The reasons for expected poorer performance were spelled out by the government's advisers, none of which supported the decision. The Ministry of Economic Development, the Treasury and the Crown Company Monitoring Advisory Unit (CCMAU) variously pointed out that:

- current arrangements already allow limited forms of diversification;

- the proposal risks diverting the focus of management away from core business (such as ensuring reliable power supplies to Auckland);
- SOEs are not subject to normal market disciplines (such as share price performance and takeovers) and the ability to monitor them is weak.

The last point is important. Taxpayers have no way of knowing whether their investments in SOEs are yielding competitive returns. In Australia the Productivity Commission reports annually on the financial performance of government trading enterprises (and it regularly finds that many do not meet their cost of capital). CCMAU has done a poor job in not providing transparent information on SOE performance.

The cabinet paper acknowledges that at best any benefits of the new policy would be "small." The evidence cited earlier suggests they are likely to be negative. The idea that the policy could contribute meaningfully to "economic transformation" doesn't pass the laugh test.

The SOE model was always an uncomfortable halfway house. Businesses need to change and grow, yet taxpayer risks are increased by diversification. The only solution to the dilemma is privatisation.

'Public ownership of the means of production, ownership and exchange' is a policy that has failed worldwide, yet New Zealand has its head in the sand on the issue. Even the National Party, which was founded in defence of private enterprise, had a weak position on privatisation going into the last election. It ought to have been embarrassed that the government's partner, United Future, which advocates minority private shareholdings in SOEs, had a stronger one.

And the illogical basis of the government's position is illustrated by the sale of Meridian's Australian business and the sensible decision to use the proceeds to invest in Auckland roading. If it makes sense to divest SOE assets in Australia, why doesn't it make sense to divest them in New Zealand?

A 2002 Business Roundtable study concluded on the basis of World Bank estimates that New Zealand could gain over $1 billion a year or around 1% of annual GDP by privatising SOEs. That estimate made no allowance for assets held by local government, which are as large as 'Total Crown' assets.

Such moves would deepen New Zealand's capital markets, promote the 'ownership society' the government talks about, facilitate tax reductions, and reliably contribute to the government's stated goal of faster economic growth.*

*First published in *The Independent Financial Review* on 21 June 2006.

Some myths and facts about savings

There is a lot of bad economics, as well as self-interest, in public commentary about savings. Repetition of the mantra that New Zealanders are poor savers doesn't make it true.

Many commentators have failed to engage with the best work on savings in New Zealand, which comes from the Treasury and the Reserve Bank.

Much of the misinformation centres on the reported household savings rate, estimated by the OECD to be -7% of household disposable income in 2005.

However, this measure is unreliable for a variety of reasons. The most important is that it fails to capture increases in household wealth arising from appreciation in the value of assets such as homes, farms and financial investments, which clearly constitute savings (the basis of future consumption opportunities) in an economic sense. The Reserve Bank has estimated that the ratio of household net worth to disposable income increased from 282% to 537% between 1979 and 2004.

If the story of a persistent negative household savings rate were true, households would have virtually negative wealth by now, having 'dissaved' for a decade or more. Clearly this is not the case.

Secondly, as Edward Prescott, the 2004 Nobel laureate in economics, pointed out in a lecture in Auckland a fortnight ago, a focus on household savings is wrong. What matters from an economy-wide perspective is overall national savings, comprising government, business and household savings.

The three components are obviously interrelated. Government savings have greatly increased in New Zealand since the 1980s as budget deficits were turned into surpluses. So too have business savings as firms strengthened their balance sheets. But government and business savings are ultimately all 'owned' by individuals, and it is well established in economics that positive changes in one component tend to be at least partly offset by negative changes in another, as logic would suggest.

There is no evidence that New Zealand's total savings rate is abnormally low. The OECD estimates that gross national savings as a percentage of GDP was 18.4% in New Zealand in 2005, only a fraction below Australia at 19.6% and well above the United Kingdom at 14.8% and the United States at 13.1%.

Moreover, there is little evidence that governments can manipulate aggregate savings rates (other than, perhaps, by changing their own operating balances) and no reason why they should.

For example, since compulsory superannuation was introduced in Australia, its national savings rate has actually declined slightly, its household savings rate is also in negative territory and it is running a large current account deficit.

Interventions such as tax incentives or compulsory savings schemes mainly change savings patterns not levels, and often in distorting ways.

The IMF has noted that while household savings rates have declined in many OECD countries, corporate savings have strongly increased, and now account for about 70 percent of total private (household plus corporate) saving.

Some who accept that New Zealand does not have an overall savings problem and that New Zealanders appear to be saving rationally for retirement, given New Zealand Superannuation (another finding from Treasury research), nevertheless argue that there should be more private savings and less government savings.

Here there is at least a measure of common ground. The government has been over-taxing New Zealanders by running excessive surpluses. Excessive state welfare is also relevant to incentives for private savings. In addition, as Ed Prescott argued, it is better to tax consumption rather than income (which taxes savings twice). New Zealand should put relatively more weight on a consumption tax (GST) by means such as a move to a lower and flatter income tax structure, as the 2001 McLeod tax review recommended.

That review reported that "when looking at the impact of savings on the current and future well-being of New Zealanders, the most relevant measure is national savings; that is, the sum of private and government savings. On examining the available evidence and the reasons why people save, it was not clear to us that New Zealanders save too little."

No subsequent analysis, as opposed to unsubstantiated assertions, have called into question that conclusion.*

*First published in *The Independent Financial Review* on 14 June 2006.

Budget 2006: "read it and weep"

What are we to make of the 2006 budget, two weeks after the dust has settled?

Most commentators have criticised it as a 'do nothing' affair, and a missed opportunity to restore New Zealand's flagging economic fortunes. Unfortunately, the government remains in denial that its policies are weakening, not strengthening, the economy.

The projections for economic growth in the budget should be ringing alarm bells. In line with what the Business Roundtable and other commentators have been predicting, the growth rate is trending downwards, contrary to the government's stated "top priority" goal of getting New Zealand back up the international income rankings.

The budget projections suggest that economic growth in the period to 2010 is likely to average only 2.9 percent per annum, well below the government's 4 percent target and below the average rate of growth since the early 1990s.

On a per capita basis, the growth outlook is worse, indicating that wages and other incomes will rise only slowly in the period ahead.

In its forecasts released this week, the New Zealand Institute of Economic Research expects the medium-term outlook to be even weaker. New Zealand is also falling in the rankings of international competitiveness, which is a factor in the current account deficits projected in the budget documents, averaging 7% of GDP up to 2010.

The harsh reality is that, after keeping pace with Australia in terms of productivity and output growth over the past dozen or so years, New Zealand is set to fall further behind.

This is all the more regrettable in that other countries in our region are outstripping both Australia and New Zealand.

Last year the Hong Kong economy grew by 7.3% following 8.6% growth in 2004, and the government is expecting growth to average over 4 percent a year up to 2010.

Singapore is expecting 7% growth this year, up from 6% in 2005.

Per capita incomes in Hong Kong and Singapore are already 36% and 21% respectively above New Zealand's on a purchasing power parity basis, according to World Bank figures.

The key facts about Hong Kong, and even seemingly dirigiste Singapore, are that they are routinely ranked top in the indexes of economic freedom. The index rankings correlate closely with per capita incomes, growth and other measures of economic performance.

In the 1990s, New Zealand came just behind Hong Kong and Singapore in these indexes but it has now fallen to 9th equal place (in the Heritage Foundation/ *Wall Street Journal* survey).

Economic performance changes only with long lags. New Zealand's economic reformers were criticised for years before their arguments were proved right in the 1990s. Similarly, the costs of policy backsliding take time to show up. But the growth in government spending, taxation and regulation since the late 1990s is now clearly taking its toll.

Just in the two years to June 2006, government spending has increased by a massive three percentage points of GDP (from 29.2% to 32.3%). It is not possible to take such a bite out of the economy, in the form of resources diverted from the productive sector and income transfers, and expect faster growth.

The option of cutting taxes to improve incentives for growth was again spurned in the budget. As First NZ Capital put it in a budget commentary, "Clearly significant cuts to taxation have been affordable, but the government has decided to go down the path of increasing spending instead. But even on the current projections, tax cuts still remain affordable – falling debt ratios to GDP from already low levels are testament to that. Read it and weep."

In contrast to New Zealand, the Australian government cut taxes in its budget last month for the fourth year in a row.

New Zealanders already pay more tax than Australians whether measured by the ratio of total government spending (at all levels) to GDP (the best measure), the ratio of total government tax revenue to GDP, or, in most cases, personal income tax alone.

It is vitally important that public debate about the economy refocuses on these issues.

Some commentators put New Zealand's sagging growth rate down to the failings of New Zealand business: Rod Oram recently wrote, "most businesses wouldn't have a clue how to earn a living in the world economy." This is patronising claptrap: if he is so smart, why doesn't he get out there and show New Zealand business how to do it, and make a fortune in the process?

Ample economic research shows that it is overwhelmingly the quality of a country's institutions and policies that determine its economic fortunes. Businesses can only do their best within the economic framework in which they operate.

The quality of New Zealand's economic framework was bad for decades up to the 1980s; it improved significantly with the two waves of economic reform in the 1980s and early 1990s; and it is now deteriorating. The longer-term consequences are quite predictable.*

*First published in *The Otago Daily Times* on 2 June 2006.

Tertiary education: who knows best?

In early April, tertiary education minister Dr Michael Cullen announced the government's latest plans for 'fixing' tertiary education in New Zealand.

According to Dr Cullen, the way forward for the tertiary education sector involves three key elements:

- defining the 'distinctive contributions' of different types of tertiary education institutions (TEIs), so that the different parts of the sector are 'complementary';
- introducing a more centralised funding system that would see TEIs and the government negotiate 'plans' to ensure that funding went into the highest priority areas; and
- developing better quality assurance and monitoring systems that focus on outcomes.

The overall objective of the changes is to make the tertiary education sector more flexible and 'relevant' to the needs of the economy. The government is now consulting on the proposed changes which won't be implemented until 2008 at the earliest.

It is hard to disagree with the objectives of the government's announced changes. We all want a tertiary education system that is of high quality, is flexible and delivers skills that are relevant (although we should beware of an overly 'instrumental' approach to education). It is no secret that, despite spending billions of dollars a year on tertiary education, New Zealand is suffering from acute skill shortages.

Will the proposed changes work? I doubt it. The government's plan is predicated on the belief that Wellington bureaucrats can make better decisions than students and TEIs about what programmes should be offered or what programmes students should undertake. That is a heroic assumption and goes against the extensive history – in New Zealand and elsewhere – of failed government interventions (think post-war Soviet Union).

The reason for this is straightforward yet fundamental – central planners have neither better information nor better incentives than students and TEIs as to which skills are, or will be, in demand in the economy or what studies will give people most personal satisfaction.

Even in a country as small as New Zealand, information can be costly or impossible for the government to obtain – especially in a timely manner. And planners' informational handicaps are becoming more acute over time – given globalisation, the more diversified nature of the tertiary student body, the advent of mass education and technological developments.

Does anyone really believe that the Tertiary Education Commission, whose performance in recent years has hardly been exemplary, would have a better handle than students and TEIs on how many software engineers, linguists, forestry workers, nurses or carpenters New Zealand should be graduating? And how well placed is the TEC to respond to rapid changes in demand brought on by internal or external events?

Dr Cullen has argued that students' choices are not always rational. It is always hazardous to base policy on the premise that most people behave irrationally and do not understand their best interests. One should first examine the incentives students face (such as high government subsidies, low interest loans, and capped funding for apprenticeships). In any case, the appropriate question is whether students' decisions were better or worse than those that would have prevailed under more centralised decision-making.

Another reason to expect central decision-making to be inferior is that it is far more likely than a decentralised system to be influenced by ideologies and vested interests (including the government's own interest as owner of the network of TEIs). This is a real risk given the government's anti-competition/anti-private sector stance, which has manifested itself in a number of policy areas, but particularly in education.

A recent report prepared for the Ministry of Education argued that private training establishments (PTEs) were far more responsive to the needs of business than were state-owned polytechnics and universities. For any government interested in the national interest, that should be a tick in PTEs' favour and the government ought to be encouraging them. Instead, it has spent much of the last five years trying to shrink the PTE sector and introduced changes that have discouraged private participation in tertiary education. Dr Cullen's tertiary education announcement seems to foreshadow more of that, with its talk about 'distinctive contributions' and a 'niche' role for PTEs.

PTEs have found favour with both employers and students and now represent real competition for institutes of technology and polytechnics. This is reflected in the fact that they now represent about 15 percent of tertiary enrolments in New Zealand. Why restrict them to 'niche' provision? Seen in this light, the government's proposed focus on institutional 'differentiation' is likely to be nothing more than code for protecting state-owned TEIs from private sector competition.

A more competitive and more decentralised tertiary education system is more likely to be in the interests of students and employers. Universities and other institutions should be given more autonomy, not less. The government has a role to play in structuring such a system, but detailed micro-management is not part of it.*

*First published in *The Otago Daily Times* on 28 April 2006.

Energy efficiency: another central planning failure

Last month the Energy Efficiency and Conservation Authority (EECA) released a Situation Assessment Report on the National Energy Efficiency and Conservation Strategy.

Established in 2001, the strategy has two national targets:

- a 20% improvement in energy efficiency by 2012; and
- increasing the proportion of New Zealand's energy coming from renewable sources.

If you think this 'strategy' sounds remarkably like Soviet central planning, you wouldn't be wrong.

Indeed it has more in common with such plans. The targets are arbitrary and are unlikely to be achieved.

The Assessment Report is a catalogue of failure (although of course it doesn't use that language).

It says that there has not been "a substantial improvement in energy efficiency and renewable energy uptake at the national level."

Specifically, we find that the rate of 'improvement' in energy efficiency, as measured by EECA, has declined. Between 2001 and 2004 it improved by about 0.4% per annum, compared with an average rate of 0.75% in the previous five years.

An ex-Ministry of Economic Development official was reported as saying recently that compared with the strategy's 20 percent target, "it will be lucky if it makes more than 2 or 3 percent."

As for the renewables target, EECA reports that there has been a decline in the proportion of New Zealand's energy coming from renewable sources. Renewable energy use as a percentage of total energy use fell from 30% in 1998 to 27% in 2004.

What did Soviet planners do when they failed to meet their targets? Their usual response was to change them.

So what do we find in the Assessment Report? "The NEECS energy efficiency target of an economy-wide improvement of 20% by 2012 is unclear, difficult to translate to sectoral level and challenging to measure." EECA suggests it could be replaced by "a package of sectoral energy intensity targets."

But this would make even less sense. The energy intensity of an economy – the amount of energy used per unit of GDP – has nothing to do with the efficiency of energy use or the nation's welfare. Countries that have cheap energy

will naturally use more energy in their patterns of production than countries that don't.

New Zealand has comparative advantages in some forms of energy production and would be foolish not to exploit them. Efficiency also requires the preferences of consumers to be respected. Arbitrary targets don't respect diverse preferences.

Similarly, EECA suggests that the renewable energy target should be reconsidered. One option it proposes is to include a long-term target, "eg 2020–2050," for renewable electricity generation. Not many current bureaucrats will be around in 2050 to be held accountable for that target.

All this might be amusing if EECA's funding was not costing taxpayers a cool $22 million a year and if the whole idea of focusing on arbitrary targets rather than citizens' welfare were not fundamentally misconceived.

Obviously we want scarce energy resources to be used in ways that make the largest contribution to New Zealanders' living standards, and we want to be mindful of environmental effects. But this is true of the use of all resources. We also want water resources to be used in the most highly valued ways, for example, and not depleted unnecessarily. Think Big was an example of the folly of regarding energy as special.

In economic life, trade-offs have to be considered. It may well be efficient, for example, to 'waste' some energy (eg by keeping lights on) in order to waste less of something more valuable, like human lives. More fuel-efficient vehicles may be noisier or less safe. Mandatory energy efficiency requirements tend to fall more heavily on low-income households that are less able to afford higher-cost buildings or equipment.

Also a more energy efficient device may be used more. A modern computer is much more energy efficient than the original ENIAC but we use far more energy today on computers.

New Zealand will certainly need to expand its energy supply, and make use of non-renewable resources as well as renewables, if the government is to achieve its target of 4 percent plus annual growth to raise incomes into the top half of the OECD range.

In a recent report, the Australian Productivity Commission assessed the scope for achieving environmental gains through energy efficiency programmes as modest, and warned against mandatory measures and a national energy efficiency target. Efficient markets are the best device for promoting energy efficiency.

The economist Milton Friedman once observed that if a private firm missed relevant targets it faced the prospect of going out of business, but if a government bureaucracy did the same thing politicians would increase its budget or its powers to avoid political embarrassment.

The government has already said it will develop a National Energy Strategy as well as review the National Energy Efficiency and Conservation Strategy. Stand by for an increase in EECA's $22 million annual budget as well.*

*First published in *The Otago Daily Times* on 21 April 2006.

Productivity growth in New Zealand: will the naysayers eat their words?

How often have we been told that New Zealand is a productivity laggard?

The prime minister famously told a London School of Economics audience only four years ago that the economy 'marked time' in the 1990s (even though it grew by about 30% in the decade) and that the 1984–88 and 1990–91 reforms were failed policies.

Council of Trade Union officials routinely said things like "the neo-liberal reforms of the past 15 years have not produced a stronger economy nor improved labour productivity."

The New Zealand Institute chimed in, saying that our labour productivity is actually deteriorating relative to other countries.

Economist Brian Easton wrote just last year that "we have to move from a low productivity growth/labour extensive growth strategy to a high productivity one because the sources of labour are running out."

Even people who should have known better joined the chorus. Academic John McMillan wrote, "Productivity in New Zealand grew slowly during the 1990s." A 2001 New Zealand Institute of Economic Research report said the "lift in productivity from structural change was very small."

These claims were severely shaken by a new study released by Statistics New Zealand last week. Its key finding was that labour productivity in the sector of the economy in which it can be measured with some confidence (essentially the business sector) has grown by an impressive 2.6 per annum on average since 1988. This performance is slightly ahead of Australia's and compares favourably with most OECD countries.

Was there any excuse for the earlier myth-mongering? No. Earlier studies had also identified major productivity gains from the Douglas/Richardson reforms.

A major study by Erwin Diewert and Denis Lawrence published in 1999 found that "After 1993 there was a productivity surge. This is likely to have been aided by the effects of the labour market reforms of the early 1990s, among other things." It also found that New Zealand had roughly matched Australia's productivity performance.

A Treasury study published in 2003 reported "a noticeable improvement in market sector multifactor productivity after 1993," and OECD estimates published in the OECD Economic Outlook suggested that New Zealand's productivity performance had been similar to that of a range of other OECD countries.

It should have been obvious to any objective observer that New Zealand's stronger economic growth performance since the early 1990s, when the benefits of

the economic reforms showed up, would not have happened without improvements in productivity.

Moreover, claims about low productivity growth were inconsistent with the practical experience of many firms in increasing their efficiency, especially after the labour market was freed up.

A common finding has been that measured Australian productivity growth has owed more to capital investment than has been the case in New Zealand. However, this is not necessarily a point in Australia's favour. With its freer labour market, New Zealand did better in absorbing more low-skilled, low-productivity workers from the ranks of the unemployed into the labour force.

There are other interesting findings in the Statistics New Zealand series.

The new data show that from 1993 to 2005, when the annual average growth in output was 4.1 percent, labour productivity accounted for most of it – growing by 2.4 percent a year on average while labour input increased by 1.6 percent a year.

They also point to a marked weakening of annual average productivity growth since 2000. Compared with the 1993–2000 period, labour productivity growth halved in 2000–2005 and the multifactor productivity growth rate fell from 2.7 percent to 1.1 percent. This suggests that recent anti-growth policies such as high government spending and taxation and labour market re-regulation have been damaging to productivity and economic growth prospects, as business organisations have argued.

Moreover, the Treasury estimates that economy-wide labour productivity growth going forward will only be 1.5 percent per annum, and even this estimate may be too high.

The Statistics New Zealand study covers industries accounting for about 65 percent of the economy. Left out, notably, is the public sector. Economy-wide labour productivity improvements have been lower than those in the measured sector. This suggests that the major gains have been in private sector industries that have been deregulated and privatised whereas state-dominated sectors such as health are lagging.

Although the Statistics New Zealand series may not be the last word on the subject, the findings turn much of the debate about productivity on its head.

New Zealand does not need government working parties on private sector productivity, interventionist industry policies, forced savings schemes or a payroll tax to encourage productivity growth.

Instead it needs to press on with policies that produced the earlier gains, such as lower taxes, greater labour market freedom, less regulation of the business sector and greater attention by the government to problems of low productivity in the public sector, in areas such as health.

And it would be nice if some of the naysayers had the grace to eat their words.*

*First published in *The National Business Review* on 7 April 2006.

Business to government: please lower and flatten taxes

This week Federated Farmers, the New Zealand Business Roundtable and the New Zealand Chambers of Commerce told the government what they would like to see come out of the review of business taxation.

The other main national business organisation, Business NZ, broadly supported the proposed package, while putting more emphasis on reductions in the company tax rate. The Institute of Chartered Accountants of New Zealand, which also lent its general support, preferred personal and company tax rates to come down together and be aligned at a common level.

This represents a very broad-based expression of business community opinion on an important issue.

The review arises out of Labour's post-election agreements with United Future and New Zealand First. The government has said it will release a discussion paper on options around mid-year.

The main criteria adopted by the consortium of business organisations in developing a proposal were to reform business taxation in a way that would benefit investment, employment, productivity, competitiveness and economic growth in New Zealand; make New Zealand's tax structure internationally attractive, particularly in relation to Australia; and be fiscally responsible.

The package focuses on a lower and flatter tax structure funded from the existing provision for additional growth in operating spending or revenue reductions; modest savings in base spending; a lower operating balance; and the revenue benefits of the impetus to the economy of a lower tax structure.

The joint proposal is based on the view that a central outcome of the review should be a reduction in the rate of company tax (and related rates of tax) and a narrower gap between the top personal and company tax rates.

A company tax rate of 25 percent is proposed. The present top and upper middle personal tax rates would be reduced to 28 percent. The changes could be introduced in two steps at the start of the 2007/08 and 2009/10 tax years.

It is important to recognise that the rates of tax on companies and other entities cannot be considered in isolation from personal tax rates, since individuals are the ultimate owners of business entities. Personal and company tax are interrelated through the imputation system. Many businesses, such as sole traders and partnerships, including many farming operations, would not benefit from a business tax review that focused on company taxation alone.

The coalition agreements envisage a tax system that provides better incentives for productivity gains and improved competitiveness with Australia. The reporting in Australia of 'income' generated in New Zealand points to a company

tax rate that is no higher, and preferably lower, than Australia's rate of company tax, currently 30 percent. Australia is expected to reduce personal income tax, and could well lower its company rate over the next few years.

It is interesting to reflect on what the package does not contain. The business sector is not calling for tax concessions or other favours. In calling for high personal tax rates to be cut along with the company rate it is also mindful of the burden of personal taxation on workers and families.

Reductions in high effective marginal tax rates, such as the top personal rate of tax, and in taxes on capital income, do most to improve incentives and boost economic growth. Growth generates widespread benefits to all income groups. Lower personal rates of tax would also help to address the high effective marginal tax rates associated with the phase-out of family and other income-related assistance.

The idea has been mooted of introducing a payroll tax to fund a reduction in company tax. This would be strongly opposed by business. The economic effect of a payroll tax would be similar to an increase in GST and involve much higher compliance and administration costs. Over time, the tax would largely be borne by workers through a reduction in post-tax wages and lower employment. Australian state payroll taxes reflect the need for an independent state tax base and do not provide a good model for central government. A move in the direction of Australia's company tax rate does not necessitate the adoption of other features of Australia's tax system.

Lower income tax rates could be announced in the 2006 budget and implemented with the first step effective from the 2007/08 tax year (ie from 1 October 2006 for companies with 'early' balance dates). There is no need for lengthy investigations and extensive legislation. There was wide support at the last election for tax reductions.

The government has said it plans 'bold' moves on business tax. The proposal is consistent with that commitment. However, if the government is not prepared to go that far, a reduction in the top personal tax rate to 33 percent and the company rate to 28 percent is recommended as an immediate step.

The proposal is also commended to other political parties, including the National Party which did not address the issue of the top personal rate of tax and the company tax rate in its election policy last year.*

*First published in *The Otago Daily Times* on 7 April 2006.

Unjustified dismissal laws are unjust

Recently there has been an interesting coincidence of developments on so-called 'employment protection' legislation.

In France, the government has passed a law making it easier to hire and fire new workers. The 'first job contract' law makes it more attractive to hire people under age 26 by giving employers the freedom to dismiss them within two years if things don't work out.

Last week new legislation in Australia dropped unfair dismissal provisions for most workplaces. For firms with over 100 workers they are scrapped for the first six months of employment.

And in New Zealand a much more limited proposal in a member's bill introduced by National MP Wayne Mapp would establish a 90-day 'probation' period in which personal grievance dismissal rules would not apply.

The French government's move is aimed at reducing France's appalling youth unemployment rate. It stands at 23% on average, and around 50% in France's poor minority suburbs which were the subject of prolonged rioting last year.

Predictably, the new law has been furiously opposed by France's privileged classes. As a Wall Street Journal editorial put it, "The student protesters, in league with the labour unions, say [the] reform chips away at France's hallowed social model that protects people in jobs at the expense of those without. Naturally, the young people who are able to find jobs include graduates of elite institutions such as the Sorbonne. Their idea of 'revolution' these days is protecting a status quo that favours them over their less-well-educated poorer peers."

A paper recently published by the German Liberal Institute made similar points. It noted that any softening of anti-dismissal legislation is attacked by combative union officials as 'social devastation' and the destruction of the 'right to work.' In countries with little anti-dismissal protection, such as the United States or Switzerland, people find new jobs much faster than in Germany. And there are many fewer long-term unemployed. In America, it is no personal failing to lose one's job and it is much easier to find a new one.

"The theory is that rigid dismissal laws protect powerless workers against the arbitrary might of brutal bosses," the study said. "The reality is that lethargic workers are protected from the competition of competent job seekers. Who in all of this is the weak and who wields the power?"

A 1996 study by US academic Charles Baird published by the Business Roundtable explained that mandatory unjustifiable dismissal laws are a tax on employment, resulting in some combination of fewer jobs and lower wages, with negative impacts on income inequality and the low-skilled.

It was interesting to note the support of three Maori Party members for Wayne Mapp's bill on its first reading.

I made the point in a paper to the Hui Taumata last year that the most disadvantaged Maori (or non-Maori) should be able to say to an employer: "Give me a chance. I realise I have a bad employment record, I've been on drugs and in prison, but I'm now determined to get my life back together. I know I can do the job you're offering and I'll work hard at it. I don't even care if you won't pay me much for a while as my family will support me, and if things don't work out you're free to dismiss me, no questions asked. But I'm confident I'll make the grade and that you'll be happy to give me a permanent job and good wages down the track."

Sadly, the freedom to make that sort of contract does not exist in New Zealand today. There is no systematic imbalance of bargaining power in the labour market that justifies such a loss of freedom.

The proposed 90-day probation period is a small step, both by the proper standard of free contracting and the provisions in Australia and many other countries.

Nevertheless, it's pleasing to see the National Party acknowledging that it was wrong in 1991 to extend mandatory rules governing dismissals (a mea culpa would be in order). Few argued that the contractual freedoms that applied to most workers (those who were not union members) were being abused.

It is also no use National arguing that it wants to see New Zealand matching Australian wage levels while only advocating timid policies. It has to make the hard arguments for sound policies, as the Howard government has done on dismissals – although it still has much work to do to improve Australia's labour market regime.*

*First published in *The Dominion Post* on 3 April 2006.

Labour markets are not special

Ideas have consequences. One body of ideas with wholly baleful consequences was the economics of Karl Marx. Although now largely defunct, it led to untold human misery in the twentieth century.

What were the central ideas of Marxist economics?

A key plank was the abolition of private property in the name of the socialist goal of equalisation of incomes. But the absence of rights to property blunts incentives to work, save and raise incomes generally. Private property is also the ultimate guarantee of personal freedoms against state oppression.

Another element of Marxism was 'public ownership of the means of production, distribution and exchange,' which led to widespread nationalisation of industry. This trend has been reversed in the last quarter century as the evidence became conclusive that, on average and over time, privately owned businesses outperform state-owned enterprises.

Progressive taxation – the notion that people should not just pay proportionately more tax as incomes rise but disproportionately more – is another Marxist idea. It can be shown to rest only on envy, not on any concept of fairness, and on the notion that incentives to be productive don't matter in the cooperative socialist utopia where income is distributed 'from each according to his means, to each according to his needs.' Interestingly, it is the countries of Eastern Europe and the former Soviet Union that have moved most strongly to proportional or flat taxes in recent years.

One of the hoariest of Marxist chestnuts is the idea that labour markets are different (in an economic sense) from other markets and are characterised by unequal bargaining power. Marx argued that employers ('capitalists') would use their stronger bargaining power to drive wages down to subsistence levels and create a 'reserve army of the unemployed.'

This fallacy is debunked in a recently published Business Roundtable study, Power In Employment Relationships: Is There an Imbalance?, by Geoff Hogbin, an economic consultant and former academic at Monash University, Melbourne.

Hogbin explains that elementary economic analysis suggests that, as for other goods and services traded through markets, wages and other terms of employment are determined largely by supply and demand. There is no reason to suppose that the employer side of the market has inherent power over the employee side.

The 'bargaining inequality' fallacy is readily exposed by reference to several empirical findings:

- Far from falling to subsistence levels (the logical consequence of inherent power imbalance) real wages in modern economies have risen steadily over the last two centuries to levels that would have seemed incredible to Marx.

- Aggregate labour income in modern economies accounts for around 65–75 percent of GDP and is not higher in the more heavily regulated labour markets of the world. Indeed it seems to be relatively higher in some of the most lightly regulated labour markets, such as the United States.
- If employers had inherent power to set wages below the value of labour's contribution to production, rates of return on capital should be higher in labour-intensive industries than in capital-intensive industries, but this is not the case.
- If employees were disadvantaged by their allegedly weak bargaining power, there are many other ways in which they could engage in productive activities (eg through self-employment, independent contracting, labour hire companies, or workers' cooperatives). The fact that individual employment contracts have remained the dominant arrangement for over two centuries is compelling evidence that they deliver greater net benefits for most workers than these alternatives.

At times there may be a sellers' or buyers' market for labour, due to supply and demand conditions, but this is so for other markets and does not reflect a systematic imbalance of bargaining power. As for other markets, wage adjustments facilitate market 'clearance' and the attainment of full employment.

The study concludes that a freely functioning labour market conducive to full employment provides the best protection for employees and employers alike against opportunistic exploitation by the other party and that labour market regulation should be neutral between individual and collective contracting.

Hogbin says, "The argument that laws to encourage the formation of trade unions and strengthen their bargaining power are required to counteract the superior bargaining power of employers is not tenable."

The alleged power imbalance is central to the view that labour markets are special and require special regulation. New Zealand's Employment Relations Act 2000 is based on the premise of an "inherent inequality of bargaining power in employment relationships."

The implications of the finding that the Marxist view of labour markets is wrongheaded are clear. New Zealand does not need the complex labour market regulation embodied in the Employment Relations Act. A basic framework of contract law which provides firms and employees with the freedom to choose arrangements that suit them best would be more conducive to productivity gains, higher wages and better employment relationships in New Zealand.*

*First published in *The Otago Daily Times* on 24 March 2006.

Is there a case for a payroll tax?

Recent media reports suggest the government may be considering a payroll tax as an option in its review of business taxation. It might be used to raise some or all of the revenue lost from a possible cut in the rate of company tax.

In response to a request from the minister of finance, the Treasury advised (on certain assumptions) that a cut in the company rate from 33% to 20% could be paid for by a payroll tax of 5.4%.

What is a payroll tax? Unlike an income tax which is a tax on labour income (wages, salaries, fringe benefits etc) and capital income (such as interest, dividends, rents and sometimes changes in the value of assets), a payroll tax is a tax on wages alone.

Although not intuitively obvious, it is equivalent (at least in simple terms) to a tax on consumption (such as GST). This is because most people spend most of what they earn in wages (or from investments based on savings from wage income) over their lifetimes.

A payroll tax could be imposed on either employers or employees, but generally speaking the ultimate cost would be borne by employees. If employers pay in the first instance, there will be an offsetting effect on wages or employment over time.

Only where labour is internationally mobile might firms be forced to increase gross wages (and maintain after-tax pay) to compensate for a payroll tax. In this case fewer such people would be employed over time as firms would make adjustments to maintain a normal return on investment.

Exporting and import competing businesses would be unable to reflect higher wage costs in their prices. They would also respond by reducing their demand for labour.

A payroll tax was introduced by the Muldoon government in the 1970s but was controversial and quickly abandoned. A number of Australian state governments have payroll taxes but a reason for this is that they need a separate revenue base (just like local government needs rates).

The comprehensive McLeod review of the New Zealand tax system in 2001 did not see merit in a payroll tax. Its main recommendation was to adopt a lower and flatter income tax structure.

Why do tax experts not favour a payroll tax at central government level? A key reason is the major practical problems that arise from the self-employed (a growing category) and investors in closely held companies being able to characterise labour income as income from capital if it bears a lower rate of tax. Also much the same economic outcomes could be achieved in New Zealand's case, with far lower administration and compliance costs, by increasing GST.

Certainly there would be gains from reducing the rate of company tax. Such a move would reduce the cost of capital, encourage additional investment and stimulate economic growth.

However, the gains would be limited unless there were parallel reductions in personal tax rates and, preferably, an alignment of the top personal rate and the company rate, as the McLeod review recommended. For a good number of businesses (such as many small businesses and farmers), the personal rate is the most relevant one for investment decisions. If the company tax rate were set well below the higher personal tax rates the current incentives to engage in tax planning and the costs and complexities of the tax system would be greatly increased.

However, a payroll tax is not needed to fund meaningful reductions in company and personal tax rates. These could be funded from the government's existing provision for new spending or revenue reductions; savings in base spending; a lower operating balance; and the revenue benefits of the impetus to the economy of a lower tax structure. The idea that a cut in wages is needed to fund a reduction in company tax would be hard to defend.

The argument that a payroll tax would force firms to economise on labour in a tight labour market and invest more in capital equipment, so raising labour productivity, is unpersuasive. We do not need a payroll tax to make that happen, and New Zealand still needs to create more jobs. Unemployment remains relatively high among young people and Maori; significant numbers of potential workers remain on benefits; and others, such as part-time or older workers, have difficulty obtaining full-time jobs.

A payroll tax/company tax reduction package would do little for economic growth and would be no substitute for a more credible growth strategy. There is no logic in the proposition that a move in the direction of Australia's company tax rate necessitates the adoption of other features of the Australian tax system.

Most business organisations, analysts and tax experts would see a reduction in wasteful government spending (and thus a lower overall tax burden), combined with a lower and flatter tax structure, as being a better approach.*

*First published in *The Otago Daily Times* on 10 March 2006.

What's wrong with Keynesian economics?

In a famous passage at the end of his major economic work, the economist John Maynard Keynes wrote:

> The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. . . Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.

Long after those words were written, Keynes was himself that influential defunct economist. His thinking, admittedly often over-extended in the hands of his adherents, cast a long and generally malign shadow.

Keynesianism was a response to the world depression of the 1930s, now widely recognised to have been triggered by ill-conceived US monetary policy and worsened by beggar-thy-neighbour protectionism.

It argued that involuntary unemployment was caused by inadequate aggregate demand – what is spent on goods and services – rather than by policy errors or an inflexible economy. Keynes' remedy was the expansion of demand by deficit financing when recession threatened, thus mitigating job losses, and contraction of demand (through budget surpluses) to prevent inflation during an economic upswing.

In practice, Keynesian economics gave a major impetus to government efforts to 'fine-tune' economies with interventionist policies and to rising government expenditure as expansion in recessions was not matched by cutbacks in recoveries.

We can observe the long shadow of Keynesianism in Robert Muldoon's public works spending, stop-go policies and Think Big programme, and in the way finance minister Michael Cullen talks about the economic cycle, 'automatic stabilisers,' fiscal tightening and loosening, curbing household spending, and tax and savings issues. Dr Cullen has described himself as "an old-fashioned Keynesian."

Even Reserve Bank governor Alan Bollard has recently fallen into the trap of blaming households and banks rather than monetary policy for causing inflation through 'excessive' spending, borrowing and lending.

Major flaws in Keynesian economics were increasingly identified in the economic literature of the 1960s as problems of timing, political will-power, adaptive expectations, and the neglect of market institutions were exposed. The stagflation of the 1970s demolished the idea that inflation was caused by excess demand.

In respect of inflation, there is now near-universal agreement that a sustained increase in the general level of prices can only have monetary origins

(through central banks printing money). Keynesian demand-pull and cost-push considerations cannot permanently increase prices.

Globalisation – the closer integration of the world economy – has also made much of Keynesian economics irrelevant. It essentially assumed a closed economy, one not open to international trade and capital movements. How demand for the goods and services produced by a small, open economy could ever be inadequate was never satisfactorily explained by Keynesian theory.

The influence of Keynesian ideas was apparent in Dr Cullen's comment to parliament's Finance and Expenditure Committee last week that a higher level of savings in New Zealand would mean lower interest rates. It wouldn't: changes in domestic savings levels could not possibly alter interest rates in the huge international capital market. New Zealand government stock is sold globally and its price is determined globally.

There has been similar confusion in the tax debate. A Keynesian view emphasises the role of tax cuts in boosting aggregate demand. But as Dan Mitchell, a tax specialist at the Heritage Foundation in Washington, recently wrote:

"Tax cuts do not help the economy by giving people more money to spend. Any money "injected" into the economy with tax cuts is offset by the money "withdrawn" from the economy as the government either reduces a surplus or increases a deficit. Instead, certain types of tax cuts can help the economy by changing the "price" of productive activity. For example, lower income tax rates mean that the relative price of working has declined. Lower tax rates on dividends and capital gains mean that the relative price of investing has declined."

Modern economic thinking has moved a long way from Keynesianism. It has rehabilitated the notion that involuntary unemployment results from the failure of economies to adjust flexibly to government- or market-induced shocks. The supply side of an economy – its productive capability and efficiency – not the demand side, is what matters most. The emphasis today in growth economics is on the institutions, policies and incentives that encourage production.

Maintaining economic stability is seen as best assured by a non-inflationary monetary policy and flexible markets, not fiscal fine-tuning.

The most important features of fiscal policy (in the absence of a debt problem) are not operating deficits or surpluses but the level and quality of government spending and the structure of the tax system.

Keynes' contribution to economics is not completely forgotten; his work reminds us, for example, that prices and wages can be 'sticky' and that markets take time to adjust. But his insights relate mainly to the short term and seldom constitute a case for government activism. For insights into longer-run issues of growth and prosperity we must look elsewhere.*

*First published in *The Otago Daily Times* on 24 February 2006.

Budget 2006: more spending and less growth

Last December the government released its latest Budget Policy Statement (BPS). It gives the government's assessment of the medium-term outlook for the economy and outlines the broad shape of the 2006 Budget.

The first striking point about the BPS is that it projects the economy's medium-term performance to deteriorate sharply. New Zealand is not on track to lift its average living standards relative to Australia or the OECD average. The projected annual average rate of growth in real GDP is only 2.8 percent during the five years to March 2010. This is far below the annual average rate achieved in the last decade and well below the 4 percent per annum rate of growth that the minister of finance has said would be the test of whether the government's growth strategy is working.

Economic growth depends, among other things, on high levels of economic freedom – modest levels of government spending, taxation and regulation. New Zealand greatly improved its rankings for economic freedom as a result of reforms that were implemented 10–15 years ago. Since then governments have lost their way. The 2006 rankings, just published by the Heritage Foundation in conjunction with the *Wall Street Journal*, saw New Zealand fall from 5th equal position in 2005 to 9th equal with Australia.

Both government spending and taxation are continuing to surge. By 2010 government taxes and levies are projected to be $14,400 per capita, nearly 70 percent higher than the 2000 level of $8,500. A very large proportion – around 60% – of the 'growth dividend' is being appropriated by the government.

The government has denied that it has been fiscally imprudent. It points to the fact that core Crown spending has fallen slightly as a percentage of GDP since it assumed office in 1999. However, this outcome is due mainly to growth in GDP (the denominator of the ratio) rather than to spending restraint. Moreover, the claim overlooks the fact that the spending ratio was projected in 1999 to decline even further (as the economy recovered from the effects of the Asian recession) and that it is now set to increase by nearly 2 percentage points by 2010. This increase in planned spending, and the dubious quality of much of it, can only be negative for growth.

Likewise the government points to World Bank research on business regulation suggesting that New Zealand scores highly as a place to do business. That outcome is a direct and welcome result of earlier economic reforms, but little has been done to build on them for over a decade. The World Bank research relates mainly to developing countries and largely measures factors that are easy to measure (eg how many days or steps it takes to set up a business). The need in New Zealand is to review the issues that are at the heart of our regulatory

environment and problems with it such as labour law, the Resource Management Act and electricity industry regulation.

The BPS states that the key initiatives in Budget 2006 will be interest-free student loans, an expanded Working for Families package, and lifting the married couple rate for New Zealand Superannuation to 66 percent of the net average wage. These involve huge increases in spending and limit the scope for reducing taxes. They involve redistribution of income to favoured groups and do little to create wealth, whereas the Treasury has recently reaffirmed that "Tax policy is a major tool that can assist in promoting economic growth."

With excessive taxation, the more productive sectors are likely to be squeezed as the state outbids them for people and other resources. This is happening at present. Employment in agriculture, hunting, fishing and manufacturing fell by 5 percent in the five years to the year ended June 2005 whereas employment in education, health, community services and other services rose by 17.5 percent.

It would be wrong to blame monetary policy for the present high real exchange rate. A high real exchange rate arises not because the overall rate of inflation is too high or too low but because inflation in the sheltered sectors where government spending is concentrated is higher than inflation in the exposed sectors – those facing international competition. Hence the saying that "monetary policy needs mates." A fiscal policy that was more supportive of monetary policy in current circumstances would see much more constrained spending by the government and lower taxation.

Business organisations will be expressing serious concerns about the outlook for growth and the economic and fiscal policy settings foreshadowed in the BPS. There is an urgent need to rein in spending, improve its quality, reduce taxes in ways recommended in the 2001 McLeod tax review, and cut back regulations.

Devices like a Taxpayer Bill of Rights and a Regulatory Responsibility Act to constrain government and expand economic freedom would help make New Zealand a more prosperous place.*

*First published in *The Otago Daily Times* on 10 February 2006.

ARC rating claims exposed

The Auckland Regional Council's claim that the business sector benefits more than proportionately from its services has been exposed as groundless by two recent reports. The claim was the key argument for the introduction of a business differential rate.

The ARC collected its rates through territorial local authorities up to 2002/03. Its general rate was levied at a uniform rate in the dollar on all rateable land.

Unbeknown to most ratepayers, territorial local authorities in the Auckland region used their rating systems to redistribute the ARC rate among property owners in their districts.

They used three different bases: annual, capital or land value. Most territorial authorities applied a differential rate to business. The general rate per dollar of rateable property used for business purposes in North Shore City, for example, was a scandalous 9 times that payable by a residential property owner.

The ARC decided to collect its rates directly from property owners following the passing of the Local Government Act 2002. In 2003/04 it levied a uniform general rate on a capital value basis. All regional councils applied a uniform rate on this basis.

The move to direct rating, coupled with a massive 34 percent increase in budgeted rates revenue, changed the initial incidence of ARC rates. Residents were faced with a large increase in rates. Some residential ratepayers mounted a rate boycott. Egged on by some territorial authorities, they attributed their plight to the absence of a business differential.

The ARC proposed a continuation of its 2003/04 policy in its draft annual plan for 2004/05 but included a differential as an option. A differential of 1.5 was subsequently adopted. Thus a business paid 50 percent more in general rates than a residential property owner with a property of the same value.

The ARC gave three main reasons for the introduction of a differential: its assessment of the beneficiaries of the services it provides, the responses it had received through public consultation, and the size of the change in rating burden for the residential and business sectors generated by the rating policy adopted in 2003/04.

Business organisations, led by the Employers and Manufacturers Association (Northern), pressed the ARC to justify its claim that business benefited disproportionately from its services.

The ARC was apparently aware that it could not substantiate its key argument. On the day that the differential was adopted, it resolved to commission a report "to assess whether there are additional benefits received by businesses that justify a differential over and above the capital value rating system."

Business proposed a joint study to resolve the impasse. The ARC backed down on this idea and decided to proceed with its own study. Associate Professor Basil Sharp of the University of Auckland was commissioned to undertake the work. His report was completed in May 2005, before the differential was increased to its present level of 1.6.

Sharp focused on what is commonly referred to as the benefit principle. His report is of considerable importance to local government because it outlines a conceptually sound and rigorous approach to the application of the benefit principle.

Councils often assert that one category of ratepayer benefits from a particular service but fail to examine adequately whether a benefit is indeed generated and to quantify the level of any such benefit.

According to Sharp, the benefits of ARC services are measured by their contribution to consumer surplus (residents) and producer surplus (businesses). Consumer surplus is the buyer's willingness to pay for a good or service net of the amount actually paid. Producer surplus is an analogous concept.

Sharp classified benefits generated by the ARC's activities as general benefits (those attributed to a broad section of the regional community) or direct benefits that accrue to business ratepayers. Direct benefits that accrue to residents were not examined.

Most benefits (76 percent by number) were classified as general benefits. General benefits should normally be funded by a uniform general rate on all rateable property.

Most activities (79 percent by number) were assessed to have a low likelihood of providing a direct benefit to businesses. Fourteen percent of activities were judged to have a medium probability of providing a direct benefit to businesses while just 7 percent were deemed to provide a high benefit.

Because Sharp could not quantify the level of direct benefits, his report does not support the main ground for the differential cited by the ARC.

Two ARC officers, seemingly anticipating that the Sharp report had demolished the ARC's main rationale for a differential, sought to expand the analysis to reflect the cost of activities that the ARC undertakes. Their memorandum was forwarded to councillors with the Sharp report.

The business organisations asked economic consultant Greg Dwyer to review the Sharp report and the ARC memorandum. He endorsed the Sharp report but was highly critical of the ARC memorandum. The latter ignored the explicit advice of Sharp that benefits could not be equated with the cost of ARC services and could not be quantified without undertaking specific empirical studies.

A large number of papers on its rating policy were supplied to Dwyer by the ARC. He reported that none contained an analysis that would justify a differential rate.

His report concluded, "The onus is on the ARC to demonstrate that its rating policy is derived from a principled analysis and reflects a genuine commitment to act in the best interests of all ratepayers and residents rather than an arbitrary policy essentially aimed at appeasing residential ratepayers. The ARC has not yet discharged that responsibility."

The ARC is preparing its draft long-term council community plan. It must revisit its rating policy knowing that the report that it commissioned does not support its argument for a differential rate and that its staff memorandum is flawed.

Unless the ARC can produce fresh and credible justification for the differential, which is extremely unlikely, it will need to be withdrawn.

The ARC may, of course, ignore the Sharp and Dwyer reports. That would, however, strengthen the case for legislation requiring councils to operate on a more principled basis in setting rates than at present.*

*First published in *The Independent* on 1 February 2006.

Reality breaks through with axing of carbon tax

The government's decision to scrap the proposed carbon tax marks another (and more positive) phase in a sorry saga of policy making on climate change.

Neither of the main political parties nor the public service comes out of it with credit.

National's minister for the environment Simon Upton was a leading evangelist on climate change in the 1990s. His enthusiasm for action ran far ahead of the scientific evidence and the economic case for governmental action to combat warming.

He attacked the Business Roundtable for bringing distinguished scientist Richard Lindzen to New Zealand to balance up the scientific debate.

Some years later the Ministry for the Environment refused to have anything to do with the visit of the sceptical environmentalist Bjorn Lomborg.

Lomborg's central argument is that Kyoto Protocol measures are simply a bad deal for the world. Even if fully implemented, at high cost to the world's economies, they would only delay projected warming by six years by 2100. The world's resources can be used to do far more good, especially for poor countries.

When the government was considering ratification of the Kyoto treaty, it neither sought nor received any advice from its public service advisers on the central question of whether it was in New Zealand's interests to do so. This was a gross failure on the part of public servants whose duty is to provide "free and frank" advice, even if ministers don't want to hear it.

Officials produced an inadequate National Interest Analysis which purported to demonstrate that adherence to Kyoto was in New Zealand's interest. A key claim in the document is that "Long term, the overall effects [of climate change on New Zealand] are expected to be increasingly negative."

Repeated efforts to get the Ministry for the Environment to substantiate this bald statement have so far failed. Clearly there would be both positive and negative effects from moderate warming. Only moderate warming for New Zealand is indicated by 2100 on the basis of the mid-point of the projected global temperature rise for a doubling of atmospheric CO_2.

The public has been fed a diet of misinformation on the issues. A case in point was the claim that New Zealand would make money out of forest sink credits.

Private sector economists questioned this at the time, and last year it was officially confirmed that New Zealand faces an estimated Kyoto liability of $440 million, rising by $110 million if the projected carbon tax gains are not recouped in other ways.

Astonishingly, however, no public servant has yet been held accountable for this egregious blunder.

It is to the credit of new energy minister David Parker that he has been willing to recognise that New Zealand's approach to climate change has been hopelessly misdirected. However, the saga is not yet at an end.

The carbon tax would have imposed serious costs on the economy for indiscernible environmental benefits. Yet the government is still talking as though the command-and-control system of emissions targets is a sensible approach to climate change, and is contemplating alternative measures.

One option it has flagged is a narrow carbon tax on electricity generators and large energy users. But what public policy rationale could there be for taxing electricity and not petrol and methane emitting activities? For the same impact on emissions, a narrow tax by definition would be more distortionary than a broad-based one and do even more harm to the economy.

In addition, talk of this kind creates ongoing uncertainty for investment. How can major energy users be expected to make sound long-term decisions while it is hanging over them?

The reality is that the Kyoto approach to climate change is dead. Commenting on the recent Montreal conference which produced nothing of real substance, the London-based Economist wrote: "Kyoto's failure is hardly surprising," given the general failure of command-and-control mechanisms. A far more promising approach is the development of more environmentally friendly technologies. Even countries such as China are prepared to go down this path: it is planning to build 30 nuclear power stations over the next two decades.

Extensive economic research has rebutted the case for early and costly action to mitigate any global warming trend. Normal market developments such as higher prices for fossil fuels as supplies become scarce, next-generation low-carbon technologies such as clean coal, cold fusion, carbon capture and storage and hydrogen (as well as renewables), and voluntary actions by business enterprises offer a far more promising approach.

The United States is winning the international debate with these arguments. Its CO_2 emissions are only 13% up on 1990 levels whereas New Zealand's have risen by 22%. Australia, another non-participant in Kyoto, also has a creditable record.

It is time for New Zealand to get off the Kyoto bandwagon and align its policies more closely with those of two of its most important trading partners.*

*First published in *The Otago Daily Times* on 27 January 2006.

Part III

2005

Perspectives on productivity

A recurrent theme of economic commentary by the government and the Treasury has been that economic growth in the past decade owed much to improvements in 'labour utilisation' and that, with unemployment now down to low levels, future growth must depend more on improvements in 'labour productivity.'

To this end the government has organised working party discussions including businesses and unions about improving workplace efficiency. The external environment established by its policy directions has been off-limits in these discussions.

Does the mantra about labour productivity make sense? Only to a point: it focuses on outcomes rather than causes and thus risks shunting policy thinking down the wrong track.

The productivity of labour, capital and other resources is certainly very important. Over the long run so-called multi-factor productivity growth is the main source of improvements in living standards for most countries. Thus Americans enjoy higher per capita incomes than New Zealanders because American workers are more productive and New Zealanders' living standards are higher than those of Indians for the same reason.

Budget projections put the estimated trend growth in labour productivity in New Zealand at 1.5% a year. This is higher than rates achieved in the decades prior to the 1990s but well below that needed to return New Zealand to the top half of the OECD income rankings in any reasonable period of time.

Economists typically define labour productivity as output per worker or per hour worked. The concept has limitations.

First, output per worker in an economy would be higher if everyone worked 60-hour weeks. Few would regard this as an improvement in general well-being. Output per hour worked is more relevant.

Second, the output of goods and services depends on other inputs such as capital, which may be substituted for labour. If substitution is occurring, observed labour productivity may be increasing rapidly but when all inputs are taken into account, multi-factor productivity could be growing more slowly or even going backwards. It is multi-factor productivity that counts.

Third, improving productivity is not necessarily about working harder or even smarter. Many of the important gains come from ongoing economic openness and flexibility – the entry and exit of firms, shifting capital and labour out of unprofitable activities and into more profitable ones, and so forth.

This is why sound institutions and policies that increase economic freedom are the key to productivity and growth.

The economic reforms of the late 1980s and early 1990s improved both labour utilisation and labour productivity in New Zealand. But the scope for improvements in both is far from exhausted.

As the Treasury noted in its briefing to the incoming government, there are around half a million people in the working age population who are not in the workforce. These comprise:

- 201,000 beneficiaries, of whom the major categories are those on the sickness and invalids benefits (83,000) and the domestic purposes benefit (63,000).
- 165,000 non-beneficiaries with a working partner, of whom 109,000 have a dependent child at home, and
- 134,000 in other categories, mainly students (59,000) and early retirees (32,000).

Many in these groups could be productively employed, at least on a part-time basis. Changes to employment and welfare rules would facilitate higher labour utilisation.

If half the number in these groups could be absorbed into the labour force, it would be expanded by one eighth and would boost economic growth. The productivity of these workers would improve over time as they gained skills on the job – labour productivity and labour utilisation are linked.

Productivity is an outcome of a good environment, not a 'driver.' The way to improve productivity is not to establish government working parties on work and management practices. It is to increase economic freedom and make business operation easier. This includes finding ways of improving incentives through such means as greater competition (eg in markets such as accident insurance), lower taxation and lighter regulatory burdens. Investment needs to be encouraged by reducing the cost of capital (eg through lower taxes on investors) and the risks (eg insecure property rights) investors face. Investment gives workers more capital with which to work. Improvements to infrastructure and to education and training are also important.

Unfortunately, too many of the government's moves have blunted incentives to be productive. For example, under the Working for Families package many people face high effective marginal tax rates if they work to increase their income, and in some cases they may be worse off. Employment law changes have made our labour market less rather than more flexible. Increasing regulation and inadequate infrastructure are making business operation more difficult.

If the government is serious about increasing productivity, it will have to broaden its thinking about the sources of productivity gains. It must also realise that its job is to set the rules of the economic game and to manage its own affairs

well (eg to improve productivity in the government-dominated health sector), not to reach for economic levers.*

*First published in *The Otago Daily Times* on 30 December 2005.

The rise and fall of nations

It is interesting to reflect on how countries fall behind in terms of economic prosperity, and then get into deep economic difficulties.

Leaving aside pathological cases like the former Soviet Union or walled-off countries like Cuba and North Korea today, there are some common patterns.

First, the rot usually sets in very slowly. It took decades for the 'British disease' to develop to the point where the British economy was moribund and had to be resuscitated by the Thatcher reforms of the 1980s.

New Zealand's Monetary and Economic Council pointed out in 1962 that the country had the worst productivity record of any industrial country since the second world war. Yet serious remedial action had to wait for over two decades.

Germany and Sweden, once top-performing economies, have been in serious difficulties for nearly 30 years. However, most of their citizens enjoy good incomes, they are resistant to change, and weak governments have not had the mandates needed to grasp the reform nettle.

Second, the economic life of countries is often throttled by the influence of special interest groups that governments pander to in return for votes. In 'old' New Zealand, business interests lobbying for protection and subsidies were a prime example. Our present government is dispensing patronage and largesse to trade unions, superannuitants and tertiary students. Wiping interest on student loans is one of the worst public policy decisions since Muldoon's National Superannuation bribe and Think Big.

Third, governments frequently give lip service to ambitious goals but take no credible action to achieve them. Thus the Bolger-Birch government of the 1990s talked of boosting growth to 3–5% a year to 2010 and reducing government spending to 30% of the economy, but it was never on track to achieve either of those goals and took no remedial action.

Fourth, governments are typically in denial that they are on the wrong track until an economic crisis looms. Muldoon told the country he was an economic wizard, justified fortress New Zealand policies on the grounds that he would not sacrifice New Zealand industries for the sake of a theory, and arrogantly claimed that people wouldn't recognise a budget deficit if they fell over one.

Our government has declared itself to be a "competent economic manager" and initially embraced ambitious goals. In its first term it said it wanted to see New Zealand reach the top half of the OECD income rankings by 2010, then it said that target date was a mistake. In its second term it reaffirmed that goal as its "top priority" without a target deadline. In its third term, the Speech from the Throne makes no reference to it.

The government has evidently realised that it is not on track to achieving any improvement in New Zealand's per capita income rankings. Its December economic and fiscal update confirmed that growth is falling away: average per capita growth is projected to be only three quarters of the rate achieved since 1992–93.

Often it takes an outsider to point out that the emperor has no clothes. This month investment adviser David Roche of Independent Strategy wrote that New Zealand's economic imbalances are unsustainable and are being made worse by fiscal policy, not to speak of the government's lack of commitment to reform.

"Fiscal policy under the Clark mark II government is redistributive of income and wealth and is stoking the economic fire rather than dousing it. So the RBNZ has to take an undeserved share of the strain by raising interest rates by more than it should were fiscal and monetary policy working in tandem.

"What is worse for the long term for New Zealand," Roche went on, "is that its new government, which represents at best a grab of power at the expense of principle, is both paralytic in terms of policy and ... untarnished by economic reform ambitions... In fact the finance minister categorized the superlative recommendations for boosting economic productivity presented to him by Treasury civil servants (and there is no better quality civil service in the world) as an "ideological burp," so showing a greater gift for invective than economics. New Zealand's income and wealth gap with Australia, and many other countries, will widen and the brain drain will worsen."

None of this is very different from what business groups in New Zealand and other economic commentators have been saying for a long time. Pending another crisis, New Zealand may be on a declining path again. But there was no sign in last week's Budget Policy Statement that the government is willing to reconsider its failed policies.*

*First published in *The Dominion Post* on 26 December 2005.

Inflation debate going off the rails

The public debate about inflation seems at serious risk of going off the rails.

Confusion abounds at several levels.

First, the Reserve Bank's action to raise interest rates is widely interpreted as reflecting a desire to slow the economy after a period of solid growth.

But isn't the government's stated aim to raise the rate of economic growth in order to lift per capita incomes into the top half of the OECD rankings?

Clearly the Bank isn't wanting to sabotage the government's "top priority" objective. It has correctly argued many times that low inflation and growth are not inconsistent – indeed that the best contribution monetary policy can make to economic growth is to keep prices stable.

So shouldn't it and the government be focusing on what is needed in other policy areas to encourage sustained non-inflationary growth?

Next, the Reserve Bank argued when increasing interest rates last week that "overall demand continues to outstrip available capacity."

But how can New Zealand demand outstrip the world's capacity to supply? And even if New Zealand demand were limited to New Zealand goods and services, the proposition is tenuous. As David Ranson, a former assistant to the secretary of the US Treasury, has written, "Skeptics rightly question how demand could constantly outstrip supply. Surely, demand must originate from purchasing power, purchasing power from wealth, wealth from income, and income from the ability to produce (and hence supply) goods and services."

'Demand pull' and 'cost push' explanations of inflation have fallen by the wayside in economics. The Philips Curve was discredited by the stagflation of the 1970s. There is no consistent relationship between inflation and unemployment, capacity utilisation and GDP growth.

Inflation is not caused by electricity price rises, the actions of 'monopoly' businesses, union wage claims or dearer oil. One price or several prices rising is not inflation. Inflation is a sustained and ongoing increase in the general level of prices.

The Reserve Bank should not be brow-beating consumers, home owners and banks about irrational behaviour. Even if it existed it could not cause inflation; commercial banks are likely to know more about managing their risks than the Reserve Bank; and the Bank's own reports indicate that the New Zealand financial system is in good shape.

Milton Friedman long ago won the debate with the demand-pull, cost-push Keynesians. As he famously said, "Inflation is always and everywhere a monetary phenomenon, in the sense that it cannot occur without a more rapid increase in the quantity of money than in output."

In other words, the inflation buck stops with the Reserve Bank, full stop.

Recently, US economist Walter Williams nicely illustrated the point with a simple parable.

"Pretend several of us gather to play a standard Monopoly game that contains $15,140 worth of money. The player who owns Boardwalk or any other property is free to sell it for any price he wishes. Given the money supply in the game, a general price level will emerge for all trades. If some property prices rise, others will fall, thereby maintaining that level.

Suppose unbeknownst to other players, I counterfeit $5,000 and introduce it into the game. Initially, that gives me tremendous purchasing power, whereby I can bid up property prices. After my $5,000 has circulated through the game, there will be a general rise in the prices – something that would have been impossible before I slipped money into the game. My example is a highly simplistic example of a real economy, but it permits us to make some basic assessments of inflation."

Only the Reserve Bank can print money. It alone should be held accountable for inflation and inflationary expectations.

Does this mean that monetary policy can operate satisfactorily regardless of other policies the government is following? No. Monetary policy needs mates.

An anti-inflationary monetary policy running up against large increases in government spending, high local government rate increases, cost-increasing employment law changes, excessive business regulations and the like can produce severe strains and imbalances (particularly for exporters and those competing with imports), as we are seeing at the present time.

What it does mean, however, is that the Reserve Bank should not be confusing public debate with defunct economics and misplaced accusations.

In respect of the housing market, for example, it should be highlighting the cost increases arising out of misguided 'smart growth' urban planning policies and excessive and poorly administered building regulations. Talk of direct interventions in the home lending and foreign exchange markets is worrying. It could take us back to the days of Muldoonist financial controls when governments wanted both lower interest rates and slower growth in lending. Trying to control price and quantity independently is sheer folly.

The problem with bad ideas and bad analysis is that they can give rise to bad policies.*

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*First published in *The Otago Daily Times* on 16 December 2005.

Does Treasury advice represent value for money?

A fortnight ago the Treasury's Briefing to the Incoming Government was released.

Treasury is the government's main economic adviser. Taxpayers fund it to the tune of around $50 million a year. Are they getting value for money for this expenditure?

The Treasury's job is to assist the government to meet its economic goals. The Labour-led government has repeatedly stated that its "top priority" goal is to raise the per capita incomes of New Zealanders into the top half of the OECD rankings. A National-led government would have a similar goal.

Readers might therefore have expected the briefing paper to focus on two central questions: is New Zealand on track to achieve that goal with current policies; and, if not, what policy changes should the government make to achieve it?

On the first question, Treasury pulls its punches. It says that "New Zealand will continue to experience reasonable rates of economic growth, although probably not sufficient to shift the country into the top half of the OECD within the next decade."

This is a massive understatement. As the briefing explains, moving into the top half of the OECD within 10 years would require growth rates of around 4% per capita per annum. This compares with average per capita growth rates of under 0.5% per annum up to the early 1990s and the much better 2% per annum rate achieved in the last decade as the benefits of the economic reforms materialised.

But a further doubling of New Zealand's per capita growth rate (from 2% to 4% per annum) is simply not in prospect on current policies. Treasury is negligent in not pointing this out.

Indeed it does not offer advice on whether current policies are likely to see any progress at all towards achieving the goal of closing the gap with the OECD average. If New Zealand maintained the small (0.3%) annual growth differential it has achieved over the OECD average in the past decade, it would take over 50 years to close the gap. Recent policy backsliding, however, makes it more likely that the economy's trend growth rate will deteriorate rather than improve.

On the second question, does the briefing paper give the government advice on the policy adjustments necessary to achieve its growth objective? Regrettably, no.

The first thing it should have pointed out is that economic growth is primarily dependent on good institutions and policies that are consistent with high levels of economic freedom and allow entrepreneurship to thrive.

Economic freedom, however, is not mentioned in the paper.

No country can be regarded as economically free, and capable of fast growth, when total government spending (central plus local) is around 40% of GDP, as is the case in New Zealand.

Cutting the government spending ratio significantly, and releasing resources for productive use in the private sector, is therefore a prerequisite to rapid growth.

It is also a prerequisite to reductions in the overall tax burden. Treasury recommends reductions to the high personal tax rates (33% and 39%) and to the company tax rate, but it doesn't suggest by how much or tie them to a government spending recommendation.

Treasury does, however, report empirical evidence indicating that high marginal tax rates on personal and company income are damaging to growth. Michael Cullen's rejection of Treasury's advice on the grounds that it is "ideological" suggests he is still in denial about the findings of economic research.

The briefing also makes a sound case for a rethink of government policies on climate change, the Resource Management Act, roading, electricity and privatisation in the interests of growth.

However, the Treasury has little to say on the barrage of regulation that is making business operation in New Zealand more difficult. To note that New Zealand compares well with other countries in many areas of regulation is irrelevant to the task of advising on policies that would achieve the government's growth objective.

It is also surprising that the briefing has nothing to say on monetary policy and the Reserve Bank's misguided attempts to blame current inflation and economic imbalances on the private sector rather than on monetary and fiscal policy mismanagement.

Nor does the Treasury engage in arguments by the Business Roundtable and other business organisations that 'constitutional' constraints such as tax and expenditure limits and a Regulatory Responsibility Act should be considered as part of a credible pro-growth strategy.

It is pleasing that there is no trace of the curious material on economic geography that featured in previous Treasury briefing papers.

So while the briefing paper is an improvement, it barely scores a pass mark. Its main weakness is the failure to advise the government that existing policies are not achieving the goal of faster growth and to outline a coherent programme that would.

In the interests of achieving the higher living standards that most New Zealanders want, taxpayers deserve better value for money from their Treasury.*

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*First published in *The Otago Daily Times* on 2 December 2005.

Full employment: not there yet

Last week Statistics New Zealand reported that the unemployment rate fell in the September quarter to 3.4 % of the labour force, a 24-year low.

This is an important achievement. New Zealand now enjoys the lowest unemployment rate among OECD member countries.

The situation is a turnaround from 1991, when unemployment reached 11 percent. At that time there was widespread pessimism that New Zealand could return to anything like full employment.

Comments like "We cannot hope to see unemployment fall below about 5–6% of the labour force," and "Children must be taught to prepare for the reality that they may never get a job" were commonplace.

Such statements were appalling and wrong.

I wrote in 1992 that "Full employment – the opportunity for anyone who wants a job to get one – is not an impossible dream."

I was confident that the freeing-up of the labour market with the Employment Contracts Act would lead to high employment growth and rapid falls in unemployment.

Indeed it did. By 1996 total employment was 18% higher than in 1991 and the unemployment rate had fallen to 6.1 percent.

In a 1994 study for the Business Roundtable, Australian academic Judith Sloan suggested unemployment could be as low as 4% by 1998 given further policy improvements, such as a rollback of damaging Employment Court rulings and stricter welfare rules.

These did not happen, however. Unemployment rose during the Asian economic crises and it took New Zealand until 2004 to get it below the 4% mark.

Some people think employers want unemployment to stay high – an ODT correspondent on 12 September spoke of them wanting to manage unemployment back to "their acceptable level": "Six to 8% would do nicely."

This idea harks back to Karl Marx's notions of a "reserve army of unemployed" and wages at subsistence levels. Like most of Marx's ideas, it is bankrupt.

An employer is perfectly happy to hire someone if their contribution to the value of output of the firm exceeds their cost. Firms' markets are expanded if more people are employed and higher wages generate more purchasing power.

Should we be happy now that the unemployment rate is 3.4% (and 2.2% for 'European/Pakeha')? Certainly not. The Maori unemployment rate is still 9.1% and youth unemployment (15–19 age group) is 12.4%.

Full employment is not a measured unemployment rate of zero – there will always be people taking time searching for jobs – but it is certainly closer to 1–2% than 3.4%.

In addition, there are many people on other benefits and many potential older workers who could be productively employed. It is wrong to argue that the only way that New Zealand can now grow is through higher labour productivity.

The key to full employment remains fewer barriers to getting a job and fewer welfare disincentives, along with better general policies for growth.

The Australian government is currently reducing employment barriers by scrapping unfair dismissal laws for SMEs (firms with under 100 employees) and establishing a 6-month probation period for larger firms.

The removal of hiring and firing restrictions benefits marginal workers in particular. As I wrote in a paper for the Hui Taumata earlier this year, the most disadvantaged Maori (or non-Maori) should be able to say to an employer: "Give me a chance. I realise I have a bad employment record, I've been on drugs and in prison, but I'm now determined to get my life back together. I know I can do the job you're offering and I'll work hard at it. I don't even care if you won't pay me much for a while as my family will support me, and if things don't work out you're free to dismiss me, no questions asked. But I'm confident I'll make the grade and that you'll be happy to give me a permanent job and good wages down the track." Sadly, that employment contract is unlawful in New Zealand today, or at least unenforceable.

Excessive employment protection laws leave marginal workers without jobs and without hope – as the riots in France demonstrate.

The best protection for any worker against unfair treatment is a state of full employment (so that alternative job opportunities are available) and common law sanctions against such things as misrepresentation and duress.

With respect to welfare, US experience has shown the dramatic reductions in welfare numbers that can be achieved with tighter rules, with most of those joining the workforce being better off than they were on benefits.

Today, the job market is generally a buyer's market – employers nationwide are crying out for staff.

This is as it should be. At full employment, firms able to pay better wages bid workers away from lower-valued employment – that is how wages rise.

But we are not there yet. There is ample scope to absorb more people into the workforce as well as to raise productivity by policies that encourage investment and growth, including investment in skills.*

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*First published in *The Otago Daily Times* on 18 November 2005.

Privatisation: a third rail?

Privatisation seems to be regarded as a 'third rail' in New Zealand politics: touch it and you're dead.

Going into the last election, no parties argued strongly that the government should get out of running businesses. Even the ACT Party was quiet on the subject. United Future proposed the sale of minority (40%) stakes in most SOEs and National's main commitments were to sell some Landcorp farms and a minority stake in Solid Energy.

This is curious. Most New Zealand privatisations were successful, in the sense of adding value to the economy, reducing prices and improving services to consumers, and increasing the profitability of enterprises.

Around the world, governments are continuing to transfer state enterprises to the private sector. Australia has been engaged in large-scale privatisation and the federal government is currently selling its remaining stake in Telstra.

The Japanese government has just won an election on its plans to privatise its postal system.

Nevertheless, privatisation has not been a popular policy in many countries. Polling suggests that 70% of Australians do not favour the Telstra sale.

Yet it seems that opposition is not intense, in the sense of having a strong influence on voting decisions. Internationally, there have been relatively few cases of renationalisation, even though buying back former state businesses is entirely feasible.

Public acceptance seems to occur after the fact. How many people today want the government to buy back NZ Steel or State Insurance?

Ownership matters. A raft of studies over the last 20 years has established that, on average and over time, the performance of privately owned businesses is superior to state-owned ones.

This does not mean that all private businesses are success stories and all SOEs are failures. What matters for public policy is the general pattern, and governments should not bet against the odds with taxpayers' money.

Why then does privatisation seem like a 'third rail' in New Zealand? After all, it is not hard to convince people that politicians usually do a poor job of running businesses (think TVNZ), compared with investors with their own money at stake.

Part of the answer may be New Zealand's atavistic attachment to socialistic policies – in this case "public ownership of the means of production, distribution and exchange."

Another part may be the failure of politicians to defend the record and dispel myths. Where arguments have been well presented, voters have been prepared

to accept them: the sale of Powerco shares by the New Plymouth City Council is a recent case in point.

Three years ago the Business Roundtable published a study addressing criticisms of New Zealand privatisations – assets were sold too cheaply, the benefits went to foreign investors, the requirement to make profits pushed up prices, and so on. Most were shown to be unfounded.

Critics commonly cite Tranz Rail and Air New Zealand as 'failures' of privatisation. Even if true, these charges would not weaken the overall case, but both are disputable.

Tranz Rail at least created more economic value than when it was government-owned; taxpayers no longer had to bail the company out at regular intervals; and there was no need for the government to get involved again – with potential future liabilities.

The immediate cause of Air New Zealand's difficulties was a bad business decision in Australia, but the government could have facilitated a sale to Singapore Airlines, to the long-term strategic benefit of the airline, had it acted promptly.

Instead it has sunk over a billion dollars of taxpayers' money into the company. Despite strenuous management efforts, shareholder value has been lost. At the present market capitalisation of $885 million, taxpayers are poorer to the tune of over $100 million.

Since the beginning of this year, the company's share price has fallen by over 30% compared with a rise of over 10% in the market as a whole.

Far from being a case study against privatisation, the Air New Zealand experience shows why politicians shouldn't force taxpayers to be exposed to business risk. Airlines are particularly risky: as Warren Buffett once observed, investors would have been done a favour if someone had shot down Kitty Hawk on its first flight.

Those who lament the level of foreign ownership of companies like Telecom overlook the fact that New Zealand institutions are typically up to their prudent portfolio limits in Telecom's stock. Some 75% of Telecom's issued capital has to be held offshore, otherwise New Zealand investors would be exposed to undue risk.

Privatisation is a pragmatic policy: it generally works. New Zealand appears to be the only OECD country with a government opposed to privatisation. This can only be an ideological position.

Central and local governments are still running business operations involving many billions of dollars of assets that would typically be managed better in the private sector.

The Business Roundtable study estimated that New Zealand could gain around 1 percent of GDP by privatising SOEs alone (leaving aside council-owned businesses). That is a lot of national income to forgo.*

*First published in *The Otago Daily Times* on 4 November 2005.

Getting better value for money in public spending

The government has embarked on a review of government spending with the aim of finding savings to offset spending decisions arising out of election commitments and the coalition agreements.

This is a welcome initiative. Government spending has been rising rapidly and is projected to blow out by a further 2 percentage points of GDP by 2008. This is a massive increase, which can only be damaging to the economy.

Total government spending currently comprises central government current spending of 30–33 percent of gross domestic product (GDP), local government current spending of 2–3 percent of GDP, gross capital formation (both sectors combined) of 2–3 percent of GDP, and other capital spending of perhaps 0.5–1.0 percent of GDP. At close to 40 percent of GDP, this level of central and local government spending is inconsistent with sustained rapid economic growth.

Finance minister Michael Cullen has demurred and pointed out that four OECD countries with such ratios of government spending achieved real per capita GDP growth of 4 percent or more since 1985. However, these countries achieved that feat only for periods of around 5 years. At least a 10-year period is needed to avoid the bias introduced by cyclical factors and to be consistent with the government's goal of returning New Zealand to the top half of the OECD income rankings. No comparable OECD country with a government spending share around New Zealand's level has achieved per capita GDP growth of 4 percent or more for as long as a decade. Those that have grown this fast, such as Ireland and South Korea, have lower spending ratios.

The deadweight costs of taxation alone make it highly unlikely that rapid growth could be achieved with high levels of government spending, even if it were uniformly of high quality. There is ample evidence, however, that much government spending in New Zealand is wasteful or poorly targeted.

The OECD has commented critically on New Zealand's budgetary processes: "There was, and still is, no systematic framework for assessing value for money… Although the budget process forces a detailed examination of new spending proposals, this represents only 5 percent of total expenditure. There is no centrally driven, systematic or regular review of the remaining 95 percent."

This is a remarkable statement, especially given New Zealand's habit of regarding itself as a world leader in public sector financial management.

What can be done about these problems?

One proposal advocated by the Business Roundtable is to complement New Zealand's fiscal responsibility rules (now re-enacted in the Public Finance Act) by the addition of a tax and expenditure limit (TEL) provision, along the lines

of the fiscal constitutions of a number of US states. This would be a 'top down' constraint that would limit the rate of growth of government spending to population growth plus inflation, unless voters decided otherwise in a referendum. Surplus revenue would be returned to taxpayers. There would be provisions to deal with exceptional circumstances.

Dr Cullen has criticised this idea as undemocratic and ideological. Yet in response to democratic pressures, many US states and several countries with governments of different political persuasions have adopted such a rule or variants of it.

Another response would be for the Treasury to establish formal guidelines for government spending. It is astonishing that none exist. This contrasts unfavourably with the effort the Ministry of Economic Development has made to improve the quality of regulatory policy through the requirement in the Cabinet Office Manual for a Regulatory Impact and Business Compliance Cost Statement to accompany regulatory proposals.

What might a good set of spending guidelines look like? One possibility would be to adopt a framework similar to that adopted in the guidelines for evaluating government regulations. These require, *inter alia*, that (1) the problem requiring a possible intervention be defined and its causes established; (2) a public policy objective be determined that is not so narrow as to prejustify the recommended policy; (3) all practicable alternatives be identified, including market alternatives, and (4) the benefits from the recommended course of action should exceed the costs when compared to the best alternative course of action. Such a set of guidelines for government spending would, if adhered to and applied professionally, make it harder for wasteful spending to persist.

A fundamental review of base spending is also required. The first step would be a screening aimed at determining which programmes serve a public purpose and represent an appropriate role for government.

This filter should identify a large number of activities as candidates for opening up to competition or withdrawing government from entirely.

Leading candidates would be government commercial enterprises. Exiting from these activities would contribute directly to economic growth and allow governments to focus on performing their core roles better.

The role of governments in providing other private goods should be critically assessed. Greater use of user pays policies, reduced middle class 'churning' and targeted assistance, in combination with private sector competition, would reveal whether such services represented value for money in the eyes of users.

The remaining programmes would be concentrated in the core public good functions of government that are less amenable to the disciplines of competition and choice. This necessitates greater emphasis on clarifying objectives, allocating decision rights and monitoring and rewarding performance. An important task

here would be to revitalise public sector management. The impetus to better performance dating from the second half of the 1980s appears to have waned.

An approach that has been adopted by a number of governments would be to set up an independent spending review commission or task force. Such an exercise would allow the government to tap expertise from outside the public service and get well-informed and independent advice.

Reducing the share of government spending in the economy by a combination of keeping spending growth below the growth rate of the economy and cutting wasteful spending is feasible, as the experience of many countries demonstrates. In its recent budget, the Hong Kong government projects a fall in public spending as a percentage of GDP from 20.2 percent in 2005–06 to 16.0 percent in 2009–10, and a cut in actual spending in that period.

Wasteful spending in government is a worldwide problem that worsened in the industrialised world with the growth in government from the 1960s. There is evidence that the expansion of government has harmed economic performance without improving social outcomes.

Effective responses to this problem require action across a broad front. Fundamental to all of them is the need for much greater public awareness of the need to focus government on its indispensable core activities.*

*First published in *The New Zealand Herald* on 31 October 2005.

Workplace reform in Australia

A fortnight ago, the Australian government announced the long-awaited details of its workplace relations reforms, although the legislation itself remains under wraps.

This package follows earlier moves by the Keating and Howard governments to free up employment contracting and shift from national and industry-wide awards to enterprise bargaining.

Called *WorkChoices: A New Workplace Relations System*, the latest initiative takes the deregulation process further.

It establishes a national workplace relations system for the first time, replacing six state industrial systems plus the Commonwealth's Industrial Relations Commission.

The framework will facilitate employment arrangements based on individual and enterprise agreements rather than the award system based on centralised arbitration and collective bargaining. This is expected to fade away.

A new, independent Australian Fair Pay Commission will set legal minimum wage rates, paying more attention to the impact on unemployed workers seeking employment than was the case under the IRC.

Two points of interest from a New Zealand perspective are provisions governing unfair dismissals and holidays.

Businesses that employ up to 100 employees will be exempt from unfair dismissal laws. For those over 100, an employee must have been employed for six months before they can pursue a claim. Dismissal on a variety of grounds such as trade union membership remains prohibited.

The distinction between small and large firms makes no sense, and Australian Treasurer Peter Costello has already signalled that it may be revisited in future.

Nevertheless, the move recognises that restrictions on terminating unsatisfactory employment arrangements are a barrier to hiring in the first place, and so push up unemployment or reduce wages as employers offset the risk.

As in New Zealand, it has become commonplace for Australian firms to resort to paying "go-away money" to avoid litigation over unfair dismissal claims.

Even Australian Labor Party leader Kim Beazley has acknowledged the problem for employers: "If you can get the small businessman to shut his shop for a couple of days ... put him through the mill, it'll be worth ten grand for him to send you away."

If adopted, the new regime will go a long way to granting employers the same freedom to terminate an employment contract, subject to any agreed provisions, that employees have to quit.

WorkChoices will also allow employees to request to cash out up to two weeks of their minimum four weeks paid leave entitlement every twelve months. This decision is for the employee to make on the grounds that "the employee is best placed to judge their work-life balance," and employers will be able to refuse a request to cash out leave.

In these two areas, Australian employment legislation will be less restrictive than New Zealand's. The Australian reforms will be occurring at a time when New Zealand law has moved in the opposite direction.

International comparisons of labour market regulation are difficult, but the Fraser Institute of Canada ranked New Zealand only in 33rd place for labour market freedom in 2002, below Hong Kong (3rd), the United States (7th), the United Kingdom (17th) and Australia (25th). New Zealand's ranking was down from 9th in 1999. The planned moves in Australia will see its score improve while moves since 2002 in New Zealand have increased employment restrictions.

The Howard government's reforms will reduce union privileges in Australia, where union membership has already fallen to about 23% of the workforce (it is fractionally lower at 22% in New Zealand). More Australian workers are demanding customised work arrangements, rather than union-negotiated collective agreements, to balance work and family responsibilities and cater for lifestyle preferences.

Speaking for the Business Council of Australia (the equivalent of the New Zealand Business Roundtable), vice-president Michael Chaney said the proposed changes could have gone further, but would help productivity and the economy by making hiring easier and more flexible.

Although the package is being fiercely opposed by the trade union movement and the Labor Party, it seems likely to be implemented and will give Australia new advantages in attracting investment and meeting global competition.*

*First published in *The Dominion Post* on 25 October 2005.

Global warming and Kyoto becoming decoupled

Events relating to the Kyoto Protocol on climate change are continuing to move at speed.

It may turn out that one of the most significant was the statement by British prime minister Tony Blair in New York last month.

Blair, a longstanding supporter of the Kyoto treaty, prefaced his remarks by saying he was going to speak with “brutal honesty,” and acknowledged that his thinking on the matter had changed.

“The truth,” he said, “is no country is going to cut its growth or consumption substantially in the light of a long-term environmental problem.”

That is, no democratically elected government could impose large economic costs on its citizens today for minimal environmental benefits a century into the future.

That much has been obvious to thinking observers for years. If the case for such action were robust, governments could have hoped to carry their electorates with them. It never was, and unsurprisingly Kyoto appears to be falling apart.

Even weaker was the argument that although meeting Kyoto targets would not achieve much, more stringent action could be taken in the second commitment period (after 2012) and beyond. That was like expecting future governments not just to shoot themselves in the foot but to blow off their legs.

It cannot be too strongly emphasised that the current debate is not about whether global warming is happening or not, or whether whatever warming there is can be blamed on human action. It is about whether the Kyoto Protocol makes sense as a response to any problem.

In New Zealand’s case, the logic that appears to have driven Blair to change his mind is even more compelling.

A report for the Greenhouse Policy Coalition by economic consultancy firm Castalia released this week makes it clear that it will be impossible to meet our Kyoto targets without causing unacceptable economic hardship.

It explains why policy to date was based on false premises regarding the potential for energy efficiency improvements, structural changes in the economy and the benefits of forestry sinks.

By 2012, New Zealand’s emissions are expected to exceed its Kyoto target by about 35%. With nearly 50% of New Zealand’s emissions coming from agriculture, and other industries having to be shielded to prevent carbon ‘leakage’ to other countries, achieving the necessary level of emissions reductions from other industries and households is simply out of the question.

Many other countries including Canada and Japan, and even the European Union as a whole, are also well off a path to reaching their targets. Only countries

whose economies have collapsed since 1990 or that have been able to switch easily from coal to gas (like the United Kingdom) have achieved significant emissions reductions. Generally, countries with growing economies and populations are projected to increase emissions until such time as new low-carbon technologies become available.

These developments come on top of the recent discovery that New Zealand faces a fiscal liability of over $300 million in the first commitment period, a House of Lords committee report questioning the objectivity of the Intergovernmental Panel on Climate Change, signs of second thoughts by other governments, and the government's decision to review its climate change policy. The British government has just announced a similar review.

What is likely to happen? Prime minister Blair made it clear in New York that Kyoto or a successor treaty is not the answer: "What countries are prepared to do ... is to develop the science and technology [otherwise] there is no way we are going to tackle this problem." Promoting technological advances and delaying action, if it proves warranted, until the economics stacks up is what eco-realists have been saying all along. It is also essentially the approach that the United States, and now the wider Asia-Pacific group which also includes China, India, Japan, Australia and South Korea, is promoting.

Two parties with support arrangements with the new government have positions on Kyoto that differ from those that Labour and the Greens took into the election, and the government has agreed to a review.

Especially pleasing is the provision in the agreement with United Future that "a new cost benefit analysis of the proposal to introduce a carbon tax as part of our Kyoto obligations will be conducted and no legislation will be introduced before the analysis is completed."

No competent analysis of this sort was done before New Zealand ratified the Kyoto Protocol, and the costs of the decision were seriously miscalculated. This was a gross failing on the part of government agencies, and chief executives should be held to account. Governments cannot be expected to make sound decisions in the absence of competent analysis.

Given the international developments and the compelling evidence in the Castalia report, it is to be hoped that logic and politics come together to evolve a better, post-Kyoto, New Zealand approach to climate change.*

*First published in *The Otago Daily Times* on 21 October 2005.

Why the Greens' charm offensive failed

Last week the Green Party invited representatives of business to a briefing aimed at demonstrating that there was no reason to be frightened about its influence on the new government.

The so-called charm offensive did not succeed. Why?

Some commentaries, such as a *Dominion Post* editorial, wrongly put the failure down to an uncompromising attitude on the part of business and an unwillingness to consider green views.

In fact Green policies are well understood by business groups and some of them line up, such as the party's opposition to the Cullen superannuation fund.

However, the Greens do not have a monopoly on environmental concerns. I have been a member of an environmental organisation, and no one I know in business is against sound environmental policies. All other parties have environmental policies: the issue is which are best.

While the initiative was welcome, Green Party policies need to be examined rigorously.

A common view of greens generally is that they are well-intentioned and at worst harmless, if somewhat utopian in their ideas.

There is no basis for complacent assumptions. Many green crusades have been responsible for human misery and environmental damage.

A classic example is the campaign against DDT. Despite massive evidence that DDT was not harmful to humans or wildlife, the ideological ban on its use in many countries led to a resurgence in malaria and an estimated *50 million* deaths. South Africa has gone back to using DDT and deaths have fallen away.

Greenpeace's infamous campaign against the disposal of the Brent Spar oil platform at sea led to its disposal on land at greater economic and environmental cost.

Greenpeace founder Patrick Moore has written that the environmentalists' campaign against biotechnology in general, and genetic engineering – an environment-friendly technology in many respects – in particular, "has clearly exposed their intellectual and moral bankruptcy."

GE is an example of green ideology at work in New Zealand in place of evidence-based policy. The Greens refused to accept the advice of a Royal Commission set up at their behest that New Zealand should avail itself – cautiously – of this new technology.

Other Green arguments are demonstrably wrong as a matter of simple economics.

One example I gave at the briefing is the proposition that a natural disaster, like Hurricane Katrina, adds to GDP because of the need to spend money on

goods and services to repair the damage. A moment's thought indicates why this is absurd – would several Katrinas be even better for GDP? Of course not – investment worth billions of dollars in houses, businesses and infrastructure was destroyed, and the resources being diverted to restoration would otherwise have been put to more highly valued uses.

Another is the proposition that reduced import protection is a cause of New Zealand's large current account deficit, hence the Green's policy of increasing tariffs and opposing free trade agreements. There is no empirical relationship between a country's current account position and its level of tariffs, which are a tax on exports as well as imports because they raise domestic costs.

Other Green policies that would be economically damaging, especially to the poor, include 'smart growth' restrictions on land supply that push up the costs of housing, and a $12 minimum wage which would price many low-skilled workers out of jobs and make them dependent on welfare benefits that are set well below the present minimum wage.

Another iconic green policy, the Kyoto Protocol, would impose large economic costs for negligible environmental benefits, as even its supporters acknowledge. The Greens seem unwilling to accept that Kyoto is not going to happen – one country after another looks set to ignore its commitments – and that the US approach to global warming, based on research and technology, is likely to carry the day.

Too often greens were largely missing in action in debates that economic reformers also saw as having environmental benefits – the abolition of fertiliser subsidies, Think Big, the ITQ system for fisheries and producer board reform are examples.

Today they are not to the fore in pushing for economic pricing, markets and commercial operation in water and roading. The Greens have blocked sensible reforms to the RMA to give better protection to property rights and require compensation for takings. They seem unwilling to engage with well-documented criticisms of doom-mongering, such as the work of Julian Simon and Bjorn Lomborg.

Unfortunately, Green Party representatives at the briefing did not reveal a readiness to rethink flawed arguments. Greens elsewhere have shown more willingness to move on from outdated positions, recognise that economic growth and environmental improvement usually go hand in hand, and put more emphasis on market-based solutions to environmental problems instead of central planning and regulation.

Such an evolution in Green Party thinking here, better analysis and a sharper focus on New Zealand's real environmental problems would make for a more productive dialogue with business.*

*First published in *The Otago Daily Times* on 7 October 2005.

MMP means Much More Paralysis

Last week Alan Wood, one of Australia's most respected economic commentators, wrote in *The Australian*: "Predicting the outcome of New Zealand elections is particularly hazardous because it has the most absurd electoral system of any Western democracy, including Tasmania and the ACT."

Wood might have added "apart from Germany," since New Zealand's mixed member proportional (MMP) system is similar to the German electoral model. According to the Royal Commission on the Electoral System, Germany is the only country to use MMP (although others use other forms of proportional representation).

When the Royal Commission recommended in favour of MMP in 1986, Germany looked to many people to be a successful country economically. To some it still does – finance minister Michael Cullen has been a long-term admirer of what he calls the 'Rhenish model.'

The admiration is misplaced. Germany rose from the ashes of World War II to become a prosperous nation thanks to the free-market policies associated with chancellor Konrad Adenauer and, particularly, economic minister Ludwig Erhard. But by the 1970s stagnation was setting in with the growth of intervention, deal-making between businesses and trade unions, a big welfare state and high taxation. In the last 10 years, average annual economic growth in Germany has collapsed to 1.3 percent (compared to 3.4 percent in the United States and 3.1 percent in New Zealand), according to International Monetary Fund figures. Germany's unemployment rate is 11 percent – similar to New Zealand's peak rate of unemployment prior to the labour market reforms of the early 1990s.

Despite its moribund economy and the widespread recognition of the need to prune the expensive welfare state, loosen labour regulations, cut taxes and wind back public intervention in business, the German political system has thwarted reform. As in New Zealand, Germany's election last weekend has delivered an inconclusive result. The 'sick man of Europe' is likely to remain bedridden for some time yet.

Of course the economy is not the only thing that matters. The basic test of an electoral system is not what economic policies it delivers but whether it makes for a sound democracy. No system is perfect but MMP has serious defects. It tends to throw up weak governments without strong mandates; gives small parties excessive influence in coalitions; institutionalises promise-breaking in post-election negotiations; gives power to central party hierarchies in drawing up lists, so that candidates that are rejected in constituencies end up back in office; and, perhaps most importantly, makes it difficult for voters to decisively throw out a failing government.

From an economic perspective, however, there are other problems. Research suggests government spending tends to be around 5 percent of GDP higher in countries with proportional representation systems, and high spending and taxation are a drag on growth. The reason for high spending is that parties do deals at the expense of the taxpayer – such as the $5 billion planned spend-up by National and NZ First after the first MMP election. Also such systems are conducive to paralysis in decision making because of the difficulties of managing coalitions, and to compromised and lower quality policy outcomes.

From many perspectives, New Zealand's election outcome could hardly be worse. Overseas investors will be shaking their heads about the prospects of a country that has to cobble together agreements between perhaps five or six parties to form an administration.

Prime minister Helen Clark has rightly emphasised the need for strong and stable government. Stability is more difficult with PR systems, and in any case it is not the only requirement. As Germany's experience shows, countries also need to be able to continuously adapt and reform their institutions to cope with economic challenges or they run the risk of long-term decline.

Since the advent of MMP, New Zealand has done little to build on the earlier reforms that have delivered today's stronger economy. There is no sign of the further improvement in its growth rate necessary to rejoin the ranks of the high income countries. Indeed the return to greater intervention and an end to favourable economic conditions are pointing to a weakening economy and a need for tougher economic decisions. Government paralysis in this situation will be unhelpful, and may trigger a reconsideration of whether MMP suits a small, open economy that needs to be nimble and flexible.

It is voters at large who should make this assessment. There has been a public expectation of another referendum to pronounce on MMP in the light of experience with it. Helen Clark has been a critic of MMP but to date has argued that it is "too soon" to put the issue back to voters. Twelve years and four elections after the 1993 referendum, that argument is wearing thin. Germany's plight should be a warning that it would be unwise to postpone a reassessment of MMP indefinitely.*

*First published in *The Otago Daily Times* on 23 September 2005.

Why the rise of China and India can benefit us all

As is often the case with great shifts in the world economy, the rise of China and India have been met with a mix of excitement and fear in Britain, Europe and the United States. The rest of the world stands to benefit from this dramatic change, just as it benefited from the rise of the US in the 19th century – but governments must keep their economies open and flexible and not resist necessary structural changes.

In many respects China is following the earlier Asian success stories, Japan and the four "Tiger" economies, Hong Kong, Singapore, Taiwan and South Korea. At times, their prowess in low-cost manufacturing and acquisitions of western assets were seen as an economic threat before they were recognised as just another growth node in the world economy.

The opportunities flowing from China's economic growth are manifold. China is already a very open economy. Its weighted average tariff has fallen to 6% mainly due to unilateral liberalisation decisions, but liberalisation in trade and investment is now being extended as part of China's world trade organisation (WTO) commitments.

China is also becoming an increasingly important market for tourism and for services such as education. From the point of view of world consumers, having a workforce of 750m hard-working Chinese adding to world output of quality products at low prices is an enormous overall benefit.

Their rising incomes are also adding to the demand for non-Chinese products. The combination of lower prices for manufactures and higher prices for the food, energy and raw materials that Chinese consumers and industries need has led to favourable movements in the terms of trade of many countries. Opportunities to outsource production to India and China should also be counted as a benefit. Outsourcing can reduce costs and preserve the viability of firms and jobs. The world is becoming an integrated production chain.

To reap maximum advantage from China's growth, other economies will need to continuously adapt. Rigid labour markets in Europe could mean higher unemployment as Chinese exporters take advantage of the removal of quotas for textiles and clothing, or (as seen recently) prompt protectionist reactions that reduce consumer welfare and hurt already stagnant economies.

Countries with big welfare states and high levels of taxation may struggle to attract investment and grow. Burdensome and ill-justified environmental regulations, such as the Kyoto Protocol, will disadvantage countries in the face of competition from China and India, whose immediate priorities are greater prosperity for their people.

New Zealand is an example of a country that is well placed to benefit from the arrival of China (and India) on the world economic stage. It has substantially liberalised its economy, including its labour markets and is now close to eliminating its remaining low tariffs. The government is negotiating a free trade agreement with China. If that happens it may be the first of its kind for China, and it would not require major additional adjustments for New Zealand industries. Nevertheless, New Zealand will need to work hard to reduce taxes, improve education standards and abandon foolish policies like Kyoto if it is to maximise the new opportunities in the dynamic Asia-Pacific region.

China's development and integration into the world economy may not be without tensions, such as weak enforcement of copyrights and other intellectual property. China's allegedly "undervalued" currency has been an issue for the US and other governments. This concern is largely misplaced: no country can permanently alter its real exchange rate. With the fixed peg between the renminbi and the dollar, China was effectively "outsourcing" its monetary policy to the Federal Reserve and accepting the US inflation rate. It has now implemented a small revaluation and swapped this peg for a link to a trade weighted basket of currencies and thus a "world" inflation rate – not a major change.

China's reluctance to liberalise its capital markets faster given current weaknesses in its banking system is understandable. Along with India, it faces many additional challenges, including environmental pollution and the scourge of corruption.

India has lagged behind China, but it has advantages over China which may count in the next 50 years: a British legal system, the English language, and democracy. China's ultimate challenge may well be political: can it manage a transition from an authoritarian regime to a law-abiding democracy without social upheaval? A chaotic, poor and militant China would be in nobody's interests.

There are grounds for optimism. Capitalism, democracy and freedom are spreading around the world. Neither China nor India looks like becoming a big-government welfare state. In fact trends are in the opposite direction.

People are the world's ultimate resource. The increasingly educated and sophisticated citizens of the world's two most populous countries seem set to add hugely to the world's stock of knowledge, scientific breakthroughs and technological innovation in coming decades. This could be their greatest contribution to living standards around the world.*

*First published in *The Reform Journal* on 18 September 2005.

The dynamic effects of tax cuts

Those who argue that tax cuts mean cuts to public spending take an unduly static view. They ignore the wisdom of President J F Kennedy's observation:

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

Elaborating on this point, Kennedy explained:

Lower rates of taxation will stimulate economic activity and so raise the levels of personal and corporate income as to yield within a few years an increased – not a reduced – flow of revenues to the federal government.

This argument should not be taken to extremes. Finance minister Michael Cullen is right to pour scorn on the view of naïve US 'supply siders' in the 1980s that tax cuts would quickly pay for themselves. But he is wrong not to acknowledge that they are partially self-funding: they do not require spending cuts of the same magnitude.

Tax cuts have both static and dynamic effects.

The static or first-round effect is that cuts in income tax boost after-tax incomes and spending. As a result we expect lower income tax collections but higher tax collections from GST, other indirect taxes and the corporate tax. Treasury's best estimate is that a one dollar cut in the amount of income tax collected will increase revenue from other taxes by 17 cents, for a net short-term revenue loss of 83 cents.

However, there are also second-round or dynamic effects. One is that people may respond to tax cuts by reducing tax planning or 'cash economy' activities. If so, taxable income will rise, reducing the revenue cost of the tax cut. Second, people are likely to change their work effort or output in response to changes in tax rates. Tax rates can affect, for example, people's labour force participation, age of retirement, overtime hours, desire for promotion, and emigration decisions. So tax cuts could increase the overall level of output and income in the community as a 'one-off' effect. Third, tax cuts could lift the rate of economic growth (ie future incomes) by improving incentives to save, invest and innovate.

These factors are very important but are more difficult to quantify. A lot of research effort is going into assessing their size. A reputable estimate is that for the United States, aggregate taxable income is likely to rise by around 0.4% within three years from a tax cut that would reduce static after-tax income by 1%.

On this basis, a reduction of one cent in the top statutory rate of income tax (eg from 39 cents to 38 cents on income of $60,000 or over) could increase taxable income by around 0.2% for a taxpayer earning $100,000. The initial cost

to income tax revenue of that drop in the tax rate would be $400. Allow for Treasury's 17 cents offset and the static revenue loss is $332. If pre-tax income lifts within three years to $100,200, as research suggests, the revenue loss in year three would drop to $235. This combination of static and dynamic effects is a bit under 60% of the initial $400 cost to revenue, ie about 40% of the initial loss is recouped.

Even more important than this offset are the adverse longer-term effects of excessive tax rates on incentives to invest, innovate or work in New Zealand. Australian economist Winton Bates has estimated that reducing the size of government (central plus local) in New Zealand by 10% of GDP (eg from its present level of around 40% of GDP to 30%) could increase the growth rate by around 0.6% per annum for perhaps 15–25 years.

Rapid and sustained growth and the revenue associated with it would swamp revenue losses from tax reductions. Government spending in Ireland fell from over 50% of the economy to under a third between 1987 and 2000. Ireland experienced a virtuous circle of lower taxes, faster growth and more government revenue to spend on health and education.

Projected growth rates under current policies are nowhere near high enough to return standards of living in New Zealand to the top half of the OECD rankings or generate revenue for large increases in social spending. Tax cuts and their relationship to public services need to be assessed in a growth context, as President Kennedy argued.*

*First published in *The Dominion Post* on 12 September 2005.

New Rights New Zealand: myths, moralities and markets

by Dolores Janiewski and Paul Morris

Auckland University Press, 206 pp, $34.99

This book is a blast from the past. Through the 1980s and '90s a succession of academics and journalists – Jane Kelsey, Brian Easton, Bruce Jesson, Paul Dalziel, Jonathan Boston, Simon Collins and Finlay Macdonald, to name a few – wrote diatribes about New Zealand's economic reforms. They harped on about 'failed policies' and a takeover by a mythical 'New Right.'

Several years ago this flow of material dried up. Facts overtook the debate, the benefits of the reforms were plain to (almost) all, and market-oriented policies were seen to be internationally orthodox. Some of the critics even had the grace to say 'sorry.'

Now out of the blue comes this throwback from Janiewski and Morris, academics from Victoria University, with no background in economics, still gripped by the spectre of the 'New Right.'

As I wrote in 1997, "I have yet to meet anyone who regards themselves as part of the 'New Right' or holds the views attributed to it. The term is a substitute for thought and is meaningless historically, politically and in every other way."

The inaccuracies and misrepresentation in the book beggar belief. It is hard to know whether they reflect ignorance or wilful distortion.

Two instances: the authors state (p 78) that "[Adam] Smith argued that the market, when given free rein, allowed the pursuit of self-interest to produce the collective good." This is a caricature of Smith's 'invisible hand' metaphor.

They tell us that "The proponents of the New Right insist that the market will always deliver better or purer outcomes than the distortions caused by any government interventions." This is pure myth. Anyone interested in testing this claim should read Chapter 14 of the Treasury's 1984 Economic Management. It noted that "Few, if any societies leave the entire range of 'economic' activity to be determined by market outcomes," and argued that the relevant question was not whether the government should intervene but "what set of interventions is most appropriate?"

Some of the material seems wilfully misleading. For example, reference is made (twice) on p 97 to Roger Douglas's Guaranteed Minimum Family Income scheme as the 'minimal family income' scheme.

Factual errors abound: it was news to this reviewer that he had been seconded to the Australian Treasury and met Anthony Fisher of the Institute of Economic Affairs (p 47).

Nowhere do the authors engage seriously with liberal arguments: their style is simply to list proponents and critics of views and side with the latter. For example, they report (p 163) "an Anglican bishop" (actually Archbishop Brian Davis) as supporting the views of writers like David Green and Michael Novak about the moral properties of markets, and then without evaluation recite the criticisms of other 'church leaders.' The latter have gone strangely silent in recent years, despite the Labour government maintaining most previous policies and not reversing the 1990s benefit cuts (or is it just because of the change of government?).

The book is bereft of any economic and factual understanding. It talks (p 175) of "the end of political commitment to full employment" at a time when New Zealand has the lowest unemployment rate in the OECD! We read, "The market in practice continually failed to deliver the promised benefits" when even the Clark government has put the economy's strong performance down to the economic reforms and stopped talking about 'failed policies.'

No serious economist ever argued 'There are no alternatives' to a programme of economic liberalisation. Of course there were: the issue was whether they made sense. As the authors say, Brian Easton proposed "a return to a corporatist consensus" (p 33). Who advocates that today?

As an account of the economic and intellectual influences behind market liberalism, the book is a confused and illogical mess. My advice to anyone considering using it to understand the thinking behind the changes in New Zealand in the last 20 years is: don't waste your time. Stick to orthodox economic sources: professional journals, international agencies, Treasury and Reserve Bank publications – or just read the London-based Economist.*

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*First published in *The Press* on 10 September 2005.

Market-oriented policies are mainstream

Recently Business New Zealand polled its members on initiatives they would like the next government to take.

Respondents expressed support for policies that were most aligned with those of National and ACT.

A 'Mood of the Boardroom' survey published in the New Zealand Herald this week reported that a majority of corporate leaders (nearly 90%) also considered the policies of the centre-right parties would be more effective than those of Labour in growing the economy and raising living standards.

Some politicians have responded by painting support for market-oriented policies as 'radical,' 'hardline' and 'right wing.'

Such labels were often applied to the 1980s Labour government's liberalising reforms. They were misplaced: the reforms were motivated far more by the realisation that past policies had failed, and that orthodox economic analysis pointed to the need for less interventionist government and a greater role for private enterprise.

Twenty years later it is even clearer that New Zealand's policy reorientation was in line with the international mainstream, and with moves by governments on both the political 'left' and 'right.'

All OECD governments, without exception, and many others, most notably China and India, have opened up their economies, deregulated markets, moved state-owned business to the private sector, and cut high tax rates.

A recent study reports that for 23 OECD countries the average decline in the top personal tax rate was 22.3 percent in the period 1980–2001.

The most recent Fraser Institute economic freedom index ranks Hong Kong, Singapore, New Zealand, Switzerland, United Kingdom, United States, Australia, Canada, Ireland and Luxembourg as the top 10 countries for economic freedom. In many of these countries, both governments of the left and right have been in office in the past 20 years. None is described internationally as having 'radical,' 'hardline' policies.

There are no signs of a reversal of this general trend. After the collapse of the socialist regimes and following the Reagan and Thatcher reforms, some political movements (such as Tony Blair's Labour Party in the United Kingdom and Labour in New Zealand) espoused so-called 'third way' policies.

This language is seldom heard today. The freer 'anglosphere' economies (United Kingdom, Ireland, United States, Canada, Australia and New Zealand – and possibly India should be added to this list) are outperforming the 'third way' European welfare states.

It is a safe bet that within the next decade Germany and some other European countries will be forced to move in a similar direction – regardless of which parties are in office.

Some of the manifestations of these trends have come from interesting quarters. Examples are the move towards flat rates of tax in several ex-Soviet Union countries, and the pressure for school choice (including education vouchers) among 'left wing' US think tanks and African-Americans.

These developments reflect an understanding that policies aimed at choice, competition and wealth creation do far more to help the poor than state welfare, control and redistribution.

A current priority of the Blair Labour government is to introduce more private sector involvement and 'internal markets' in areas like health, education and prison management.

Governments of all political persuasions are using the private sector to fund and operate infrastructure such as roads and water and sewerage. Federal and state Labor governments in Australia have gone down this path.

The Howard government in Australia is moving ahead with labour market deregulation, welfare reform and privatisation. Leaders in both the Liberal and Labor parties, and even the Australian trade union movement, are calling for cuts in high tax rates.

The advice of the OECD, which represents the views of its advanced country members, is in line with that of New Zealand business organisations.

Today it would be fair to claim that, internationally, policies of renationalisation and more 'hands on' government are contrary to mainstream directions. Business organisations, reflecting the views of their members, believe they harm New Zealand's growth prospects.

Amongst business organisations, this does not translate into an attachment to any political party, unlike the trade union movement and teacher organisations which are openly partisan.

Representative business organisations today are much more focused on what's best for New Zealand at large, not self-servingly on narrow business interests.

The approach is not 'What's good for General Motors (ie business) is good for America.' Clearly corporate welfare could help some businesses but at the expense of the general community. The business sector is now generally opposed to subsidies and protection, and understands that what's best for the economy is also best for business in the longer run.

What ultimately counts is the state of public understanding and opinion on directions for a successful country. This is influenced by arguments based on sound analysis and by national and international experience.

In democracies, governments change their minds in response to changes in public opinion, or electorates change governments.

That's the way it should be.*

*First published in *The Otago Daily Times* on 9 September 2005.

Funding tertiary education

The debate over funding tertiary education has become confused in recent years.

Two separate issues need to be disentangled. The first is what proportion of tuition costs should students pay in fees. The second is how the cost of those fees should be met.

Who should pay? There are two main alternatives: students and their parents, or taxpayers.

If all the future benefits of a student's higher education went to other people – the public at large – then the answer to the question 'Who should pay?' would be taxpayers. In this scenario, students would not care which courses they took: they would get no financial or other benefits from their choice.

Clearly, this scenario is unrealistic. Students generally derive substantial benefits from higher education, not least a higher earning potential. They choose their courses in relation to their own aptitudes and judgments on what would benefit them most.

There are other arguments for student contributions to the costs of tuition: most students come from better off backgrounds and go on to enjoy higher lifetime earnings than other taxpayers on average; tertiary institutions have stronger incentives to meet students' needs; students have stronger incentives to make good course choices and work hard.

In addition, governments in coming years will be under pressure to devote more resources to meet the health and other needs of an ageing population, while constraining taxes to internationally competitive levels. Taxpayer resources to fund higher education will be limited, and in the absence of student fees the quality of institutions will decline and access will be rationed.

What proportion of tuition costs should students bear? Currently the average is around 25–30%. The last major official examination of this question was by the 1994 Ministerial Consultative Group. Four of its 10 members supported a progressive increase to 50% on an income-contingent basis and in combination with targeted assistance. Four supported a rise to 25%, and the others (student representatives) supported essentially the status quo (then around 20%).

The debate on taxpayer support for tertiary education should focus on the level of tuition subsidies (and student allowances). Subsidies should not be channelled through the loans scheme.

How the cost of student contributions should be met is a separate matter. The sources of first resort should be a combination of parents' saving plans, part-time and vacation work by students, employer bonds, bank loans and scholarships. Such arrangements are the norm in the United States, which is widely regarded as having the world's most successful higher education system. In New Zealand

about half of all students (and/or their parents) currently meet tuition fees and living costs without taking out a student loan.

A government loan scheme to overcome any capital market failures should be a funding source of last resort. There is nothing wrong, however, with borrowing to invest in human capital. Much commentary focuses on student debt as though it is not matched with any asset. If it is really being argued that New Zealand tertiary education is a worthless asset, we should be seriously concerned.

Making a government loan scheme concessional in addition to subsidising fees is a serious mistake. It encourages excessive borrowing and creates incentives to rort the system.

The government's decision to make loans interest-free while students are studying has increased student debt. Labour's proposal to wipe interest altogether for borrowers resident in New Zealand would compound the problem. It discriminates against students who have avoided borrowing, means taxes will be higher than otherwise, and does nothing to increase resources available to tertiary institutions.

In addition, as Nicholas Barr of the London School of Economics has pointed out, forgoing interest helps the wrong people:

- It does not help students (graduates make repayments, not students).
- It does not help low-earning graduates early in their careers – with income-contingent loans, repayments depend only on earnings, thus interest rates have no effect on the size of repayments, only on the duration of the loan.
- The only people it helps are higher-earning graduates in mid-career, whose loan repayments terminate earlier than would otherwise be the case.

National's plan to make interest on loans tax deductible is also misguided. Deductibility goes together with taxable income. We don't make home mortgage interest payments tax deductible because the imputed rental value of owner-occupied houses is not taxed. Nor do we tax increases in capital value. The situation with student loans is analogous. Like housing, education is already preferentially treated for tax purposes.

A better alternative to both these proposals is to cut taxes.

Tertiary education is expensive. Public policy for funding it needs to be based on sound principles.

Recent governments have failed to spell out clearly the respective rationales of fees and loans. Unless they do, vested interest groups like student associations will continue to lobby for more subsidies and we risk ending up with more bad public policy in this area.*

*First published in *The Otago Daily Times* on 26 August 2005.

New Zealanders are more highly taxed than Australians

In a recent speech, finance minister Michael Cullen declared that it was a "myth" that taxes are high in New Zealand and that "if anyone tells you that Australians pay less tax, your best response is: baloney." He is wrong.

The ratio of government spending to GDP is the best measure of the overall tax burden. Deficits and surpluses tend to balance out over time, and most of what governments spend must be raised in tax.

On this basis, overall tax burdens are lower in Australia. The OECD's December 2004 *Economic Outlook* forecast that spending by governments at all levels would total 35.8 percent of GDP in Australia and 38.7 percent in New Zealand in 2005.

An alternative measure is overall taxation. On this basis, accounting firm Staples Rodway calculated that Tax Freedom Day came 7 days earlier in Australia than in New Zealand this year – meaning that the tax burden is 5% higher in New Zealand.

These approaches avoid the problems of comparing the different features of the two tax systems, including different bases and rates for income tax and GST. In particular, looking at statutory income tax rates alone – Australia's two top personal tax rates are 42% and 47%, compared with rates of 33% and 39% in New Zealand – can be very misleading.

Nevertheless, a proper analysis even of personal income tax alone tells the same story.

Dr Cullen focused on income tax comparisons to make an argument that a New Zealander earning either the average New Zealand wage, $41,400, or 1.5 times the average wage, $62,100, would pay less tax than someone earning an equivalent income in Australia. However, his analysis confuses apples with oranges, uses an inappropriate exchange rate and rests on misleading examples.

The accompanying chart shows the whole picture for incomes up to NZ$100,000. It calculates an individual's income tax liability in New Zealand for each level of income (as a ratio of gross income) and subtracts from that the corresponding ratio for the equivalent level of income in Australia. An IMF purchasing power parity exchange rate for 2005 of NZ$1=A$0.917 is used.

On this basis, which is consistent with Dr Cullen's methodology, the chart shows that New Zealanders have a higher average income tax rate than Australians for the whole income range examined. For lower incomes this is largely because the first A$6,000 of income in Australia is tax free, whereas tax at 15% applies in New Zealand. At the higher levels of income in the chart, the New Zealand tax burden is higher primarily because the relevant Australian tax

rate of 30% is lower than the New Zealand rates of 33% and 39% and it extends to A$70,000 (equivalent to NZ$76,000).

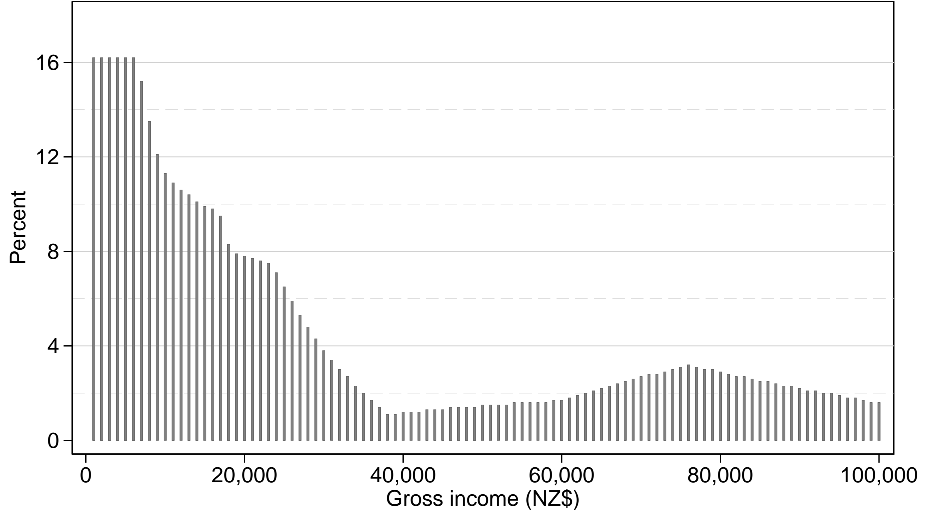
So where does Dr Cullen's "baloney" argument come from? The answer may be from ex-CTU economist and his former economic adviser, Peter Harris. According to its website, the Public Service Association commissioned Harris in May 2005 to explore the "myth" of the exploding public sector. Using the July 2006 Australian tax scale, Harris calculated that a single New Zealand taxpayer on $41,400 would pay 20.6% of that income in income tax, whereas on the equivalent Australian wage of A$39,000 (implying an exceptionally higher exchange rate of NZ$1=A$0.942) Australian income tax would be 19.4%, increased to 20.9% if the Australian Medicare levy were included. In his speech, Dr Cullen omitted the 19.4% figure and claimed that taxes were higher in Australia at 20.9% compared to 20.6%.

This is an apples and oranges comparison. At an income of NZ$41,400, the ACC levy in New Zealand is 1.2 percent and the Medicare levy in Australia on the equivalent income is 1.5 percent. Exclude the Medicare levy, use a more appropriate exchange rate and the gap at NZ$41,400 is 1.5 percentage points in favour of Australia, as indicated on the chart. Include the Medicare and ACC levies and the gap is 1.2 percentage points. If these levies were included in the chart, the disparity for low income New Zealanders would be greater because there is no Medicare levy in Australia at lower incomes.

A comparison at the $62,100 income level produces a similar result, as the chart illustrates.

Other complicating factors could be analysed, but the overall picture is clear. Whether you look at a government expenditure measure, an overall tax burden calculation, or an income tax comparison for the vast majority of taxpayers, New Zealanders are more highly taxed than Australians for the same level of income.*

*First published in *The New Zealand Herald* on 24 August 2005.



Note: The chart excludes ACC and Medicare levies.

Sustainability

In 2001, the Danish academic and former Greenpeace member Bjorn Lomborg published his acclaimed book *The Skeptical Environmentalist: Measuring the Real State of the World*. In it he exposed the litany of environmental myths of the last 30 years and painstakingly documented the evidence that environmental quality has generally been steadily improving, at least in the developed world. In Lomborg's own words, the message of his book is that:

> ... children born today – in both the industrialized world and the developing countries – will live longer and be healthier, they will get more food, a better education, a higher standard of living, more leisure time and far more possibilities – without the global environment being destroyed.

I know of no one who favours unsustainable development. But Lomborg's argument is that development is sustainable. Indeed, more often than not, economic progress and environmental improvement go hand in hand.

It is sometimes suggested that New Zealanders value quality of life ahead of economic growth and higher incomes. But this is a confusing statement. Decent incomes, along with a good environment and other things like leisure and safe communities, are part of the quality of life.

As New Zealanders, we greatly value the quality of our environment but that does not mean we are unconcerned about our material well-being. Indeed, surveys seem to suggest that New Zealanders are no more 'green' than people in comparable countries; where we differ most is in our desire for higher incomes. This should be no surprise: our average incomes declined for a long period relative to those in other advanced countries, and we have only begun to catch up again in the last decade.

In my view, it is better to talk directly about what constitutes good economic and environmental policy than to invoke the language of 'sustainability.' Sustainable development is a problematical term. The common definition is development that "meets the needs of the present without compromising the ability of future generations to meet their own needs."

But how do we know what the needs of future generations will be? A hundred years ago many people were worried about running out of whale oil for lighting, firewood for heating and horses for transportation. With changing technology, what will people need in 2100? Moreover, a concern for intergenerational equity needs to take account of the fact that future generations will almost certainly be far better off than present generations. How much should relatively poor people today be asked to sacrifice to benefit future generations whose living standards may be equivalent to those of today's mega-wealthy? The most important

things to leave future generations are a growing capital stock, technology, sound institutions and, above all, a capacity to innovate.

Much of the concern about sustainability focuses on depletion of natural resources. But natural resources are generally becoming more plentiful, not less – prices have been in long-term decline in real terms. In 1970, global reserves of copper were estimated at 280 million tonnes. During the next 30 years about 270 million tonnes were consumed. Yet at the turn of the century estimated reserves stood at 340 million tonnes, not 10 million. Available supplies have surged, and at the same time substitutes for copper such as fibre optics have come into widespread use.

The same is true even for oil. Global reserves of oil in 2000, at 1,050 billion barrels, compared with 580 billion barrels in 1970. Sheik Yamani, founder of the Organisation of Petroleum Exporting Countries, has often pointed out that the oil age will come to an end but not for a lack of oil (oil will be displaced by other fuels, especially renewables), just as the Stone Age came to an end but not for a lack of stones. While some natural resources may be finite, human ingenuity is not.

What about pollution? On the whole, rich countries are less polluted than poor countries, not more. As Indian prime minister Indira Gandhi put it, "poverty is the worst polluter." Richer countries employ cleaner technologies and have more resources to devote to environmental protection. The main safeguards against pollution (including global warming, if concerted international action to combat it turns out to be warranted) are secure property rights (so that people take care of what they own), free markets (so that resources go to their most highly valued uses), and economic prices (which reflect the true cost of resources). However, sound environmental regulations, particularly those targeted at negative external effects of economic activity, also have a role to play.

The concept of a 'triple bottom line' that is sometimes invoked in the name of 'sustainability' is even more problematical. Its advocates want businesses to pursue not just a financial bottom line but social and environmental bottom lines as well.

There are several problems with this concept.

First, few would argue that companies should not be socially and environmentally responsible, but that does not exhaust their responsibilities. Why not add other "bottom lines," such as an ethical bottom line and a corporate governance bottom line? The concept is arbitrary.

Second, as *The Economist* noted in an article earlier this year:

> Measuring profits is fairly straightforward; measuring environmental protection and social justice is not. The difficulty is partly that there is no single yardstick for measuring progress in those areas. How is any given success for environmental action to

> be weighed against any given advance in social justice – or, for that matter against any given change in profits? And how are the three to be traded off against each other?...
>
> Measuring profits – the good old single bottom line – offers a pretty clear test of business success. The triple bottom line does not.

Third, as *The Economist* went on to point out, the problem is not just that there is no one yardstick allowing the three measures to be compared with each other. It is also that there is no agreement on what progress on the environment, or progress in the social sphere, actually mean – not, at least, if you are trying to be precise about it. In other words, there are no yardsticks by which different aspects of environmental protection can be compared even with each other, let alone with other criteria. And the same goes for social justice.

Fourth, the great virtue of the single bottom line is that it holds managers to account for something. Triple bottom line objectives blur the accountability of boards and managements for performance. There can be no objection to firms choosing to report on environmental or social aspects of their operations to their shareholders or wider stakeholders. Doing so according to some triple bottom line metric, however, is unlikely to be meaningful. It should also be for companies themselves to decide voluntarily what reporting (beyond legal requirements) is in the best interests of their shareholders, having regard to costs. The taskforce set up by the Institute of Chartered Accountants of New Zealand to examine sustainable development reporting was right to come down in its 2003 report against mandatory reporting.

In passing, it should be noted that proclamations of corporate virtue and dedication to notions such as sustainability should not be taken at face value. Sometimes what is involved is little more than self-serving public relations or a strategy to buy favours. Enron was America's triple bottom line company par excellence, but it came up several bottom lines short.

There is no need for those in business to be defensive about its social role. Serving the material needs of fellow human beings is a noble vocation. Profit-oriented enterprise in competitive markets is the best system we know for creating wealth and lifting living standards. Profits are a prima facie signal that society's resources are being put to good use. Other institutions (like charities) cater for other needs. We should allow businesses to perform their prime social role and not burden them with other, inappropriate, ones.

In summary, sustainable development stems from the same kind of institutions we need to advance other social goals, in particular political and economic systems based on secure property rights and the rule of law. As more and more countries are appreciating, these are the basis of economic prosperity, but economic prosperity also leads to improved environmental quality by raising demands for it and providing the wherewithal to meet those demands. Concepts

like sustainability and the triple bottom line are well-intentioned, but they tend not to lead to clear thinking about what constitutes sound public policies. We have better analytical tools at hand for meeting both economic and environmental challenges.*

*First published in *The Institute of Chartered Accountants Journal (Volume 84 No 7)* on 16 August 2005.

Improving regulatory disciplines

A sound framework of regulation is needed to facilitate business transactions and help achieve other economic, social and environmental goals.

This does not necessarily call for statutory intervention. The alternative to statutory regulation is not no regulation but rather regulation by private law, including the common law. The common law is sometimes called judge-made law as it arises from rulings made by judges, not politicians. Typically it develops in incremental fashion and is respectful of business customs and practices.

The common law rules on property, contracts and torts governed commerce before the modern era. They continue to do so and could have broader application, for example by displacing much ill-conceived employment legislation. Statute law may be superior to common law in some situations (for example the common law may not be able to handle pollution from diffuse sources well) and inferior in others.

For the same reason the policy issue is not regulation or deregulation, but rather the best form of regulation.

New Zealand implemented major regulatory reforms over the past 20 years that increased overall the scope for voluntary exchange. As a result its scores have risen in the indexes of economic freedom and, consistent with other experience, its economic performance has greatly improved.

World Bank research suggests that New Zealand generally ranks high today for the ease of doing business. Nevertheless, the recent trend has been towards freedom-reducing regulation in areas such as labour markets, network industries, safety and the environment. This threatens the ongoing vitality of the economy.

Business commentary on this trend often focuses on the costs of complying with regulations. Compliance costs are usually the tip of the iceberg. For example, the costs of obtaining resource consents under the Resource Management Act can be dwarfed by the economic costs of delays or of projects not proceeding at all. As the chairman of Australian Productivity Commission, Gary Banks, recently noted:

> More damaging from a broader economic perspective can be the impacts on incentives for entrepreneurship and innovation, the distorting of decision-making away from the most productive avenues, or constraints on firm responsiveness to changing market conditions.

Much regulation that purports to be in the general public interest is in fact a response to self-interested lobbying by narrow groups. A challenge is to constrain governments in their regulatory roles so that their decisions reflect the broader public interest.

One potentially useful approach is the requirement in the Cabinet Office Manual for a Regulatory Impact and Business Compliance Cost Statement to accompany bills. This aims to ensure that the benefits of proposed regulations exceed their costs. In practice, many such statements have been of poor quality and bad legislation has been enacted. Cost benefit assessments are not sufficiently robust to be relied on alone.

A 2001 report prepared for the Business Roundtable, Federated Farmers and the Auckland and Wellington chambers of commerce explored the possibility of applying disciplines like those in the Reserve Bank Act and the Fiscal Responsibility Act to regulatory policy making. It canvassed the idea of a Regulatory Responsibility Act along the lines recommended by the Institute.

Regulation typically affects the value of economic assets. One feature of a Regulatory Responsibility Act suggested in the report is an extension of the concepts of the Public Works Act into other areas of regulation and a requirement for compensation where private economic rights are altered in the public interest.

The report also recommended a major one-off review of existing regulations.

It is pleasing that some political parties have given in-principle support to strengthening the disciplines on regulatory policy, including support for the concept of a Regulatory Responsibility Act.

The barrage of new and amending laws and regulations in recent years is making business operation in New Zealand more difficult, and reducing the potential for economic growth, higher living standards and wider personal freedoms.

A greater attachment to constitutional principles and more respect for freedom of contract and security of property rights – that is, for the rule of law – is needed, together with processes of the kind recommended by the Institute, if regulatory excesses are to be reduced in a sustained way.*

*First published in *The Institute of Chartered Accountants Journal (Volume 84 No 7)* on 16 August 2005.

Should we fear China?

According to Martin Wolf in his acclaimed book, *Why Globalization Works*, "The fall of the Soviet empire and the shift of China and India from socialism and self-sufficiency to liberalization and international exchange were the most important events of the last two decades of the twentieth century for the world economy."

Although China and India are still classified as "mostly unfree" countries, both have moved up in the Fraser Institute's indexes of economic freedom – from a score of 3.8 out of 10 in China's case in 1980 to 5.7 in 2002, and from 4.9 to 6.3 in the case of India. Predictably, their economic performance has improved; annual economic growth in the last 10 years averaged 8% in China and 6% in India.

As is often the case with structural shifts in the world economy, these developments have been met with a mix of excitement and fear in the rest of the world. Are they threats to jobs and industries or do they present opportunities?

A simple way to rephrase the question is to ask: 'Will the rest of the world be better off if China grows rich or if it stays poor?' The answer is obvious. From an economic perspective, and probably from other perspectives as well, the rest of the world stands to benefit from the rise of China, just as it benefited from the rise of the United States in the nineteenth century. The proviso is that governments keep their economies open and flexible and do not resist necessary structural changes.

From the point of view of world consumers, having a workforce of 750 million hard-working Chinese adding to world output of quality products at low prices is an enormous overall benefit.

Their rising incomes are also adding to the demand for non-Chinese products. The combination of lower prices for manufactures and higher prices for the food, energy and raw materials that Chinese consumers and industries need has led to favourable movements in the terms of trade of many countries, including New Zealand.

To reap maximum advantage from China's growth, other economies will need to continuously adapt. Countries with rigid labour markets, big welfare states and high levels of taxation may struggle to attract investment and grow. Likewise the adoption of ill-justified environmental regulation, such as the Kyoto Protocol requirements, will disadvantage countries in the face of competition from China and India, whose immediate priorities are greater prosperity for their people.

New Zealand is well placed to benefit from the arrival of these countries on the world economic stage. It has substantially liberalised its economy, including its labour markets, and is now close to eliminating remaining low tariffs. The

government is negotiating a free trade agreement with China. If it eventuates it may be the first of its kind for China, and it would not require major additional adjustments for New Zealand industries. Nevertheless, New Zealand will need to work hard to reduce taxes, improve education standards and abandon foolish policies like Kyoto if it is to maximise the new opportunities in the dynamic Asia-Pacific region.

China's development and integration into the world economy may not be without tensions.

One major issue for Western firms is violation of copyrights and other intellectual property. China has taken steps to give constitutional status to property rights, but enforcement remains weak. It must overcome this problem in its own interests: no country has prospered with insecure property rights for its own investors or foreigners.

China's allegedly 'under-valued' currency has been an issue for the United States and other governments. This concern is largely misplaced: no country can permanently alter its real exchange rate. With the fixed peg been the yuan and the US dollar, China was effectively 'outsourcing' its monetary policy to the Federal Reserve and accepting the US inflation rate. It has now implemented a small revaluation and swapped this peg for a link to a trade-weighted basket of currencies and thus a 'world' inflation rate – not a major change.

China's reluctance to liberalise its capital markets faster given current weaknesses in its banking system is understandable. Along with India, it faces many additional challenges, including environmental pollution, the scourge of corruption and an inevitable transition to political freedom and democracy at some stage.

There are grounds for believing that both China and India will meet the challenges that face them. Capitalism, democracy and freedom are spreading around the world. Neither country looks like becoming a big-government welfare state – trends are in the opposite direction.

The ultimate resource for world prosperity is people. The increasingly educated and sophisticated citizens of the world's two most populous countries seem set to add hugely to the world's stock of knowledge, scientific breakthroughs and technological innovation. This could be their greatest contribution to living standards around the world in coming decades.*

*First published in *The Otago Daily Times* on 12 August 2005.

Election policies should be viewed through a growth lens

Beyond ensuring the provision of public goods (such as biosecurity and the court system), and leaving aside the production of private goods that could be more efficiently produced by the private sector, governments are not directly involved in wealth creation. Most of their other activities involve wealth redistribution.

Government redistribution up to a certain point can be growth-enhancing, but generally there is a trade-off between growth and redistribution because redistribution affects people's incentives to be productive.

There is a strong case for a social safety net, but also for limiting it so as not to throw sand in the machinery of wealth creation.

Elections are a perilous time for growth-oriented aspirations and policies. As the American writer H L Mencken put it, "Every election is a sort of advance auction sale of stolen goods." He meant that political parties promise to tax, spend or regulate to benefit some groups at the expense of others. The general public interest in wealth creation is often sacrificed.

To date, features of the election campaign bear out Mencken's observation. The National Party has promised tax breaks for childcare and student loans. These come on top of commitments to match Labour's promises of an extra week's statutory holiday and to keep the Cullen superannuation fund.

All these are essentially about redistribution, not growth.

To be fair, National is also promising changes in employment law, infrastructure provision, the RMA and tax which should have growth benefits.

Labour's main campaign commitment to date is to make most student loans interest-free. Even at the claimed annual cost of $300 million, this adds significantly to the tax burden. In its recent report on New Zealand, the OECD stated unequivocally that "higher taxes have a negative impact on economic growth."

Not only are excessive subsidies or tax concessions for tertiary education largely redistributional; they redistribute income from poorer to richer groups on average. Tertiary students come mainly from better-off backgrounds and typically go on to earn above-average incomes.

This is a classic example of so-called 'middle-class welfare,' whereby articulate and organised interests gain privileges through the political process at the expense of people who are less well off.

There are other reasons why Labour's interest-free loans scheme is bad public policy: it discriminates against students who avoid borrowing or have repaid their loans, penalises graduates who want to pursue work or study overseas, increases

the incentives to rort the system, and does nothing to increase the resources of tertiary institutions.

A far better strategy from both a growth perspective and to facilitate debt repayment would be to cut high tax rates, including the higher effective tax rates generated by the Working for Families package.

New Zealand is in no position to lose interest in growing the pie and to focus just on how it is divided. The higher incomes, employment levels and spending on health and education that New Zealanders are now enjoying are largely the result of earlier growth-oriented reforms.

But economic reform is not a one-off process, as Australian prime minister John Howard constantly points out. The Australian government's plans to press on with labour market, welfare, tax, public sector and other reforms could see income gaps between New Zealand and Australia widen further.

The government has said that increasing the economy's growth rate to restore New Zealand to the top half of the OECD income rankings is its 'top priority' objective. If it is genuine, that goal will surely be the number one item on Labour's pledge card, and be backed by credible policy announcements.

As the OECD has pointed out, an acceleration of New Zealand's trend growth rate is not in prospect with current policies. The government has defended many of its initiatives on distributional grounds but has not even tried to claim that any of them have materially improved New Zealand's sustainable growth outlook. The reality is that a large number of them will have negative effects over time: budget documents show the economy's projected growth rate trending downwards.

Only growth, not redistribution, can underpin prosperity and security. As Robert Lucas, the 1995 Nobel Laureate in economics, has put it, "Of all the tendencies that are harmful to sound economics, the most seductive, and in my opinion the most poisonous, is to focus on questions of distribution ... [O]f the vast increase in the well-being of hundreds of millions of people that has occurred in the 200-year course of the industrial revolution to date, virtually none of it can be attributed to the direct redistribution of resources from rich to poor. The potential for improving the lives of poor people by finding different ways of distributing current production is nothing compared to the apparently limitless potential of increasing production."

In the election campaign, the policies of all political parties should be scrutinised through a growth lens.*

*First published in *The Dominion Post* on 8 August 2005.

Is the Kyoto Protocol now a dead letter?

What look like significant recent developments in the fate of the Kyoto Protocol aimed at reducing greenhouse gas emissions have gone largely unreported in New Zealand.

In the lead-up to the recent Group of Eight (G-8) economic summit in Gleneagles, Scotland, British prime minister Tony Blair and other European leaders hoped to change the US position of opposition to the Protocol. Instead, at a meeting overshadowed by the terrorist bombings in London, it was the US position that prevailed.

President George Bush argued that the world should await further scientific evidence on global climate change rather than make unwise decisions that would stifle growth. As he put it in a speech before the summit, efforts to "oppose development and put the world on an energy diet" would condemn two billion people in the developing world to poverty and disease.

Over-hyped language describing global warming as "an urgent threat to the world" requiring "immediate action" was removed from the draft summit communiqué. Also eliminated were references to melting glaciers and rising seas.

Instead, the leaders of the major industrialised nations agreed that "uncertainties remain in our understanding of climate science," rejecting the environmentalist dogma (and assertions by energy minister Pete Hodgson) about "settled science."

Moreover, science cannot answer questions that are at heart economic, in particular the extent to which scarce economic resources should be used to mitigate warming or be applied in other ways, for example to reduce world poverty or improve sanitation and water quality.

To state what should be obvious, climate change science cannot predict the rate of economic growth in China and India in the next century, or their rate of growth in emissions, or the rate at which new technologies will displace fossil fuels. Nor can it calculate the economic cost of adaptation or mitigation.

European governments may be realising that any short-term effort to curb emissions using existing technologies would be prohibitively costly and further damage their sluggish economies. By some estimates, the global costs could reach well into the hundreds of billions of dollars annually, yet global temperatures in 100 years' time would be barely affected. Bjorn Lomborg, author of *The Skeptical Environmentalist*, describes Kyoto simply as a bad deal.

The push by European countries at Gleneagles to strengthen the level of international commitment to the Kyoto targets may have been weakened by the fact that carbon emissions in these countries are on the rise and most of them are not on track to meet their commitments under Kyoto.

Two other events prior to the summit reinforce the impression that Kyoto is becoming a dead letter.

The first was the release of a report on the economics of climate change by the influential Economic Affairs Committee of the House of Lords. This expressed concern that the UN Intergovernmental Panel on Climate Change was tainted by political interference, played down some positive aspects of global warming, and failed to reflect in a balanced way the relative merits of adaptation and mitigation in the face of climate change.

It stated that UK energy and climate policy "appears to be based on dubious assumptions about the roles of renewable energy and energy efficiency" and called for alternative "architectures" for future Protocols, "based perhaps on agreements on technology and its diffusion."

Secondly, efforts to push the Kyoto agenda in the US House of Representatives and Senate have recently lost ground. While the Senate did agree to a non-binding resolution declaring global warming a problem, Congress has clearly joined the Bush administration in rejecting carbon constraints in favour of the administration's strategy of research and development of new technologies.

Meanwhile, the government has revealed a major error in its calculations of the economic consequences of Kyoto, changing its estimates from a net benefit to an expected cost of $307 million of meeting New Zealand's commitments in the period 2008–2012. The government's previous assertions of economic benefits were reckless and short-term in nature; the likely high future costs were disregarded and are now expected to hit earlier.

The government has long been naïve to believe that the Kyoto targets would ever be met. Given the shaky scientific and economic foundations of the Protocol, no western government that tried to impose costly economic measures for, at best, minimal environmental gain would be likely to survive democratic elections.

Recent events suggest that Kyoto may already be in the process of being ditched and that New Zealand would be wise to abandon its current policies in favour of a more rational approach to the climate change issue. Respected economic research indicates that the optimal approach is to facilitate the development of new technologies, adopt 'no regrets' policies (ones that should be adopted anyway on economic grounds, such as congestion pricing for roads), encourage voluntary action, and avoid early and costly regulatory measures.*

*First published in *The Otago Daily Times* on 29 July 2005.

Are tax cuts inflationary?

In arguing against tax cuts, one point that finance minister Michael Cullen asserts is that they would push up prices, and that the Reserve Bank would have to raise interest rates to curb inflation.

To any serious economist, this argument is an embarrassment. Even at a superficial level, tax increases are more likely to push up prices and reductions in tax are likely to lower them.

This is easy to see with GST. When the Goods and Services Tax was introduced there was a relatively brief spike in prices. Increases in excise tax on petrol push up the CPI.

Changes in income taxes have similar effects. When the Muldoon government imposed a wage-price freeze in the early 1980s, it cut income taxes to encourage wage earners to be more moderate in their wage demands. The idea of a wage-tax trade-off was to reduce pressure on wage costs and prices.

Conversely, when the government lifted the top tax rate from 33 to 39 cents in the dollar in 2000, some firms had to increase wages so that the post-tax incomes of their workers did not fall, in order to retain them. This added to their costs and price pressures.

Where, then, does the idea that tax cuts push up prices come from?

The answer is that it is a hangover from the heyday of Keynesian economics. Dr Cullen has described himself as "an old-fashioned Keynesian."

Economists then were taught that the causes of inflation were 'cost push' or 'demand pull.' Increased taxes were an example of 'cost push' inflation.

'Demand-pull' inflation was said to derive from a surge in the demand for goods and services in general ('aggregate demand'), especially when 'aggregate supply' (the production of goods and services) was held back by capacity limitations. Tax cuts in Dr Cullen's Keynesian economic model would work this way.

But how realistic is this model? The answer is, not very.

First, if tax cuts replaced government spending of the same amount, a Keynesian model would predict a fall in demand, as some of the tax cuts would be saved rather than spent.

Second, the Keynesian model essentially represents a closed economy – ignoring capital flows and exchange rate responses. New Zealand is a small, open economy and producers in the rest of the world can easily respond to increased demand by New Zealand consumers without affecting the prices of tradable goods.

Third, tax cuts would ease capacity constraints and increase supply in New Zealand over time by improving the incentives to work and invest.

Fourth, and most important, Dr Cullen's analysis is static. Inflation is a sustained increase in the general price level, not a one-off change in prices. Even if there were a one-off effect of tax cuts on prices, why would that matter?

Inflation is a monetary phenomenon, as Milton Friedman demonstrated in his attack on Keynesian economics. Only central banks can generate inflation by printing money. The widespread acceptance of Friedman's argument has led the main central banks of the world to target inflation and reduce it to low levels since the 1980s.

Non-monetary theories of inflation based on 'demand-pull' ideas have fallen by the wayside. They were discredited by the stagflation of the 1970s.

The empirical evidence on tax cuts is consistent with this analysis.

Opponents of President Reagan's tax cuts argued that they would be inflationary, but inflation in the United States fell steeply in the 1980s.

The Bush administration has cut taxes twice and is proposing further cuts (while also hiking government spending and sending the budget into deficit). The spending and deficit budgeting can rightly be criticised, but the tax cuts have not triggered inflation and US interest rates are at historical lows.

The reality is that there is scarcely any relationship between the state of the government's budget and inflation in an open economy with a floating exchange rate. This conclusion is well established in the economic literature.

There is no evidence that low-tax economies are more prone to inflation than high-tax economies. In fact, the opposite is likely to be the case, as well-run low-tax economies tend to be more flexible. Inflation was not a problem in New Zealand when taxes were below 10% of GDP.

With public debt down to low levels, New Zealand should now strive to improve its international competitiveness and attractiveness to investment by moving to a lower-tax regime, more in line with other countries in the Asia-Pacific region.

Tax cuts, preferably accompanied by cuts in the high rates of growth of projected government spending (much of which is of poor quality) and reductions in the excessive operating surplus, would improve incentives and boost economic performance.

A sound medium-term programme of tax reductions could be implemented without any threat to macroeconomic stability. Let's have a sensible debate about taxes and spending rather than red herrings about inflation.*

*First published in *The Otago Daily Times* on 15 July 2005.

The energy hobgoblins

The great American journalist and social critic H L Mencken could have been thinking of Green politicians when he wrote: "The whole aim of practical politics is to keep the populace alarmed by menacing it with an endless series of hobgoblins, all of them imaginary."

Despite the appalling track record of environmental scaremongers from Rachel Carson to Paul Ehrlich to David Suzuki, the hobgoblin species is not at risk of extinction.

An *ODT* correspondent recently wrote, "We are at, or very close to, our energy limits now."

Nothing could be further from the truth.

The latest energy outlook assessment by ExxonMobil, the world's largest energy company, suggests that oil production is not likely to peak in the forecast period, 2003–2030.

Solid Energy has pointed out that New Zealand has enormous coal resources – about 10 times as much per capita as the global average. It has stated that the coal equivalent of 40 to 50 original Maui gas fields is economically recoverable at close to today's prices.

Bjorn Lomborg, author of *The Sceptical Environmentalist*, has noted that the shale oil that is available in the world is enough to cover current energy consumption levels for 5000 years and that shale oil will probably be economically viable within the next 25 years.

And our ultimate source of energy, the sun, is likely to be around for billions of years.

It is not good enough for critics to sneer 'Big Oil' or 'vested interests.' They have to reckon with facts and expert assessments.

Sheik Yamani, founder of the Organisation of Petroleum Exporting Countries, has often pointed out that the oil age will come to an end but not for a lack of oil, just as the Stone Age came to an end but not for a lack of stones. Humans search constantly for better alternatives.

For the next 25 years or so, however, oil, gas and coal will almost certainly remain the world's primary energy sources.

Production of wind, solar, biomass and nuclear energy will grow faster, but will still make only a modest contribution to meeting global energy demand in that period.

What the hobgoblin crowd overlooks is advances in technology. People and their ingenuity are the ultimate resource.

Some of the advances that are occurring in quite short periods of time are staggering.

A recent report out of Japan stated that a vacuum-insulated refrigerator, which comes with a buzzer if the door stays open more than 30 seconds, uses 160 kilowatt-hours of electricity a year, one-eighth of that needed by standard models a decade ago.

An air-conditioner with a robotic dust filter cleaner uses 884 kilowatt-hours, less than half of what decade-old ones consumed.

From 1973 to today, Japan's industrial sector nearly tripled its output, but kept its energy consumption roughly flat.

ExxonMobil estimates that improvements in vehicle efficiency in North America and Europe will offset growth in vehicle numbers and the associated fuel demand in the period to 2030.

It estimates that carbon emissions from the increased vehicle fleet in these countries will be at or slightly below 2003 levels in 2030.

Moreover, on the supply side, technological advances are opening up new and cheaper ways of discovering and exploiting energy resources.

This optimistic outlook is not clouded by the issue of global warming, which needs to be considered seriously but rationally.

As Julian Morris, executive director of the International Policy Network, recently pointed out, dramatic warming is unlikely to result from humanity's emissions in the next century. "The best estimates suggest a moderate warming of between one and two degrees Celsius – a change that may even be beneficial. In a slightly warmer world with more carbon dioxide, agricultural output would increase, and more food would be available at a lower cost."

Temperature increases in New Zealand are expected to be only around two thirds of any global increase. The benefits for agriculture, health and recreation need to be set alongside negative consequences of climate change.

Morris noted that in 2004, under the auspices of the Copenhagen Consensus, a group of eminent academics concluded that eradicating communicable diseases, improving access to clean water and freeing world trade would provide the greatest benefits for the world's people. By contrast, they ranked reductions in greenhouse gas emissions an extremely bad investment.

Economic and environmental goals sometimes – though by no means always – involve trade-offs. But the interests of poorer people (including in New Zealand) in getting richer should not be sacrificed at the altar of environmental mythology. Those emphasising environmental goals above all else are often among the better off in society.

In the long term, it is inconsistent to be concerned about the world running out of fossil fuels and human-induced climate change.

There are enough real problems in the world to be worried about without manufacturing imaginary ones.*

*First published in *The Otago Daily Times* on 1 July 2005.

Are New Zealanders poor savers – or just rational?

The best-selling author Michael Crichton recently wrote: “The greatest challenge facing mankind is the challenge of distinguishing reality from fantasy, truth from propaganda.”

He was talking about environmental doom-mongering but the same comment applies to the New Zealand debate about saving.

Finance minister Michael Cullen has claimed that New Zealand’s household savings rate is too low and that the country is too dependent on foreign capital. The New Zealand Institute has claimed that home ownership rates have fallen and that “New Zealand is facing a serious ownership challenge.”

In last month’s budget the government announced an additional subsidy for home ownership and a ‘compulsory opt-out’ workplace savings scheme.

But where is the evidence that New Zealanders are not making rational savings decisions, and that a wise and all-seeing government should try to change their ways?

According to Statistics New Zealand, net national saving as a percentage of national disposable income has risen strongly since the early 1990s. In 2003/04 it stood at 6.8% compared with -2.6% in 1991/92.

It is a statistical convention that government and corporate saving is not counted as household saving. But if households do not collectively own or control Crown assets and many corporate assets, who does?

Rational behaviour implies that lower ‘household’ savings should go hand in hand with higher government savings. This is what seems to have happened as large government deficits turned into large surpluses since the early 1990s. If the government wants New Zealanders to save more, perhaps it should stop over-taxing them to fund wasteful spending.

Treasury research has also found that people in retirement generally enjoy comparable or higher levels of consumption than prior to retirement. Those who say household savings are too low should explain why it would be rational for people to be even better off in retirement than during their working lives.

The claim that New Zealanders have consistently been living beyond their means over the past decade implies that their net worth has been declining. For persons other than those in retirement, this is unlikely during a period of strong economic growth, and is inconsistent with Reserve Bank data which show that the net wealth of New Zealand households has grown from around 2.8 times net disposable income in 1979 to about 5.4 times in 2004.

The New Zealand Institute has claimed that the proportion of households with negative net wealth is much higher in New Zealand (16%) than in Australia (4%).

However, this is an 'apples and oranges' comparison as the data for New Zealand are collected from individuals whereas the Australian data refer to households. The true gap is much narrower.

In any case, New Zealand is less wealthy than Australia, thanks to decades of poorer policies. Asset ownership is ultimately about a stronger growth performance and higher average incomes.

The Institute's claim that home ownership has fallen is based on data which are not robust and are likely to be revised. In any case, what is the 'right' rate of home ownership? It seems that around 70% of homes in New Zealand are owner-occupied. This is much the same rate as in the United States, and well above Germany at around 40%. If New Zealand has a "serious" ownership challenge, where is it?

The use of foreign capital is not obviously a bad thing either. New Zealand was developed on foreign capital.

In broad terms, a balance of payments deficit when the government is running a fiscal surplus signals that private investment exceeds private savings. As long as the investment is profitable it makes sense for foreigners or New Zealanders to borrow from global capital markets to fund those investments.

Furthermore, higher savings are not necessarily a good thing. They come at a cost of lower levels of current consumption, and there is no strong link between savings and economic growth.

In the final analysis, what business is it of the government to try to influence savings decisions – the choice individuals make between present and future consumption? And there is little evidence that governments can influence aggregate savings rates much anyway.

If more widespread asset ownership is the goal, an easily available option is to shift assets from state ownership to private ownership. It is hardly credible for the government to invoke an asset ownership goal and then rule out an option for achieving it which does not require households to cut current consumption.

Arguably the government's best 'savings policy' should be to promote economic growth (by and large, growth generates savings, not the other way round), to reduce distortions to saving, in particular by income tax reductions, and to make access to welfare benefits less open-ended.

Puzzlingly, the government seems to have turned its back on a credible pro-growth, tax reduction and welfare reform strategy.*

*First published in *The Otago Daily Times* on 17 June 2005.

Clearing the fog of misinformation about wages

The recent Budget was a useful antidote to some of the mythology about wages.

It pointed out that total gross earnings have risen by an average of 6.1% per annum over the past six years, driven equally by growth in employment and growth in average hourly earnings.

Thus "the benefit of the strong labour market has been evenly split between more people working and higher earnings for those in employment."

If unions think a higher share should have gone to their employed members, they should say so to those who would have missed out on jobs.

The Budget also noted that labour's share of national income has been relatively steady at an average of 42.5% of GDP. In other words, it hasn't been squeezed at the expense of profits.

Finally, the Budget reported that real wage growth has been positive over the past six years and has broadly reflected productivity growth.

This continues a longer trend. According to the National Bank's April Business Outlook, nominal wage growth over the last decade has averaged 3%, inflation 2% and labour productivity 1.2%.

Clearly the statement "The value of Kiwi wages is falling" in the full-page advertisements of the Engineering, Printing and Manufacturing Union in support of its 5% wage claim is misinformation.

Moreover, unions have been defending the huge increases in health and education spending – which they call the social wage – and the mushrooming tax take that has funded them.

They have also lobbied for employment benefits such as parental leave and enhanced holiday provisions.

All these things come at the expense of more money in the hand for workers, which many might prefer. Just the move to four weeks annual leave in 2007 may mean wage increases around 2% less for affected workers.

In competitive labour markets, wages are fundamentally determined by supply and demand for labour of a given productivity.

In aggregate they are not closely related to company profitability, which fluctuates around normal levels. Diversified investors generally absorb profit fluctuations; firms do not typically cut wages when profits are below their cost of capital.

Nor are wages much influenced by unions, which only represent some 12% of private sector workers. Globalisation and deregulation have meant wages are now set competitively – as they should be if full employment is the goal. When the labour market is tight, firms have to pay more to recruit and retain people with the skills they need, whether they like it or not.

Most workers today want to be valued as individuals. Their circumstances vary greatly, as do those of the firms they work for. The idea of a flat, across-the-board wage increase should have gone out with the ark.

The key to rising gross wages is faster growth in productivity. And the key to higher net wages is tax reductions that leave more money in workers' pockets and stimulate effort and skill acquisition.

Those with workers' interests genuinely at heart should be joining with business and other groups in calling for the removal of the many obstacles to productivity growth that have been erected in recent years and for much lower taxes – nearer the levels workers in fast-growing countries in our region enjoy.*

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*First published in *The Dominion Post* on 13 June 2005.

Budget gets a 'not achieved' grade

The government has repeatedly stated that its 'top priority' goal is faster economic growth (to return New Zealand to the top half of the OECD income rankings).

So the acid test of the budget is straightforward: is the economy is moving to a higher growth path?

The projections indicate this is not the case; in fact the trend is in the opposite direction. The government's scorecard, in NCEA parlance, is 'not achieved.'

The numbers are as follows. Real growth in gross domestic product in the decade to 2003 averaged 3.7% a year. There has been no acceleration over the government's term of office, despite generally favourable external and internal conditions.

For the next four years, the budget forecasts annual growth to fall away and average just 2.8% a year. Even more importantly, real growth in GDP per capita (a measure of material living standards) is projected to fall from an average of 2.5% over the decade to 2003 to just 1.9% in the next four years, a 20% decline.

There is no reason why New Zealand cannot lift its economic performance and catch up with richer countries. Better policies largely explain the better record in the post-1993 period. The fact that the outlook is deteriorating rather than improving can only be put down to bad policies.

A major case in point is excessive and wasteful government spending, with little regard for value for money. Treasury has been telling the government that output in the health sector is not reflecting the huge increase in funding. No comparable OECD country has achieved sustained per capita growth of 4 percent or more with New Zealand's level of government spending (central plus local) of around 40% of GDP.

The fully implemented effect of the 2004 and 2005 budgets will be a massive increase of government spending of over $3 billion a year, and by 2009 the government spending share of the economy is forecast to increase by a full 2 percentage points. Because the private sector is essentially the productive sector of the economy, expanding the government share of the economy at the expense of the private sector is a recipe for slower growth. A credible growth strategy requires smaller and less wasteful government.

The way tax is raised also matters for growth. The government has chosen a fiddling and tweaking approach to business taxation – a complex *Working for Families*-type package for business. A better policy would be simply to reduce the company tax rate (along with high personal rates).

Increasing tax thresholds, as the government is foreshadowing in a minimal way, is also an inferior policy. As the Business Council of Australia (an

organisation of CEOs similar to the Business Roundtable) recently explained, "A rate change is needed, not a threshold change. Raising the threshold at which the top marginal tax rate cuts in would reduce the average rate of tax paid by these individuals and increase their after-tax income. However, it would not alter the marginal tax rate that these individuals face when they are deciding to undertake additional saving and investment."

With both personal and business taxes, the government has missed an opportunity to implement real tax reform. Emphasising the cash balance is a return to inferior fiscal indicators, and does nothing to prove tax cuts are unaffordable, particularly if more capital expenditure were financed on normal commercial lines and greater use made of private enterprise and funding. There is ample scope to cut tax rates given greater fiscal discipline. Tax cuts are less inflationary than government spending of the same amount.

The discussion paper to be released on the Stobo tax proposals deserves consideration. However, there is no evidence of savings problems to justify the intrusive workplace savings proposals. They will impose significant costs on employers and taxpayers. Moreover, they have little to do with a serious growth strategy. As the International Monetary Fund pointed out in its recent report on New Zealand:

> Even if the proposals currently being debated do lead to an increase in aggregate savings, the effects on investment and growth are unlikely to be large as New Zealand already has easy access to international capital.

Once again the government has turned its back on policies that would improve the business environment and increase household incomes, such as lower spending and taxation (including scrapping the unjustifiable carbon tax), a greater role for private enterprise in the economy and the provision of health and education, less restrictive labour law, serious infrastructure reform including changes to the Resource Management Act, and welfare policy initiatives to reduce benefit dependency.

A failure to move in these areas, contrary to policy directions across the Tasman, means that New Zealand will slip further behind Australia and fall far short of its potential.*

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*First published in *The Otago Daily Times* on 20 May 2005.

Some taxing issues

Tax will loom large as an issue in the May 19 Budget and at the forthcoming general election.

Last year, finance minister Michael Cullen was unable to think of a tax he had reduced. Labour is committed to a higher share of government spending in the economy and hence a higher level of taxation. National and other centre right parties have pledged tax reductions to help boost economic growth.

Many of the government's arguments against tax reductions are wrong or misleading.

Dr Cullen disputes that lower taxes would spur growth. He argues, for example, that he would not work longer or harder if he had to pay less tax. This may be true in his case, but it is certainly not true of people in general.

Disincentives to work are among the so-called 'deadweight' costs of taxation, which rise exponentially as marginal tax rates increase. A 1994 study for the Business Roundtable found that the deadweight costs of taxation of labour income in New Zealand were 18 cents for every dollar of revenue raised.

Treasury analysis has suggested that reducing all income taxes to a flat rate of 19.5% would add at least 1% to economic growth over the medium term, or $1.5 billion each and every year to New Zealand's economic output.

Dr Cullen has argued that tax cuts would be irresponsible because they would add to demand pressures and force the Reserve Bank to raise interest rates. However, on this analysis, government spending increases of the same magnitude as tax cuts actually add more to demand pressures because with tax cuts some of the money is saved, not spent. The government is increasing spending by a massive $2 billion a year. A sensible programme of tax reductions phased in over a few years would be readily manageable.

Another argument of Dr Cullen's is that there is no fiscal headroom for tax cuts. Like a former minister of finance (Robert Muldoon) he is effectively arguing that 'I've spent the lot.'

But there is no reason why wasteful and poorly designed spending, such as the Working for Families package, could not be scaled back to make room for tax cuts. Also the operating surplus should be reduced, more capital expenditure should be financed by the private sector, and holding growth in government spending below the growth rate of the economy would provide ample latitude for medium-term tax cuts.

In response to calls to lower New Zealand's company tax rate from 33% to 30% to match Australia's, Dr Cullen has asked whether New Zealand businesses would also want features of Australia's tax regime such as payroll taxes and taxes on capital gains.

This is a red herring. Adopting a good feature of Australia's regime does not mean we have to adopt bad ones.

Australian business organisations have been pointing out that personal income tax rates are more important than the company tax regime in determining the amount of tax paid on business income. Businesses such as sole traders or partnerships pay the personal rate, and with the imputation system, resident investors in companies are taxed at their personal rate on dividends. However, Dr Cullen has raised New Zealand's personal rate from 33% to 39%, adding to the effective tax burden on business income.

After wages, tax is the largest cost faced by most businesses. Internationally, it is a major factor in where firms decide to invest and do business. New Zealand is a high-tax country in our region; countries like the United States, Australia, Singapore and Hong Kong all have lighter tax regimes. The high-tax economies, predominantly in Europe, are struggling to achieve economic growth.

It is also interesting to note that countries in our region are continuing to reduce high tax rates. The Bush administration has cut the top rate of federal income tax in the United States to 35%. Moreover, that rate applies at an income level of 8.5 times per capita GDP whereas the top rate in New Zealand cuts in at only 1.2 times per capita GDP. Singapore is heading towards top personal and company tax rates of 20% in an effort to maintain the real per capita GDP growth rate of 5% a year that it has achieved since 1960. In Australia, the Business Council of Australia (the equivalent of the Business Roundtable) and the Australian Chamber of Commerce and Industry are calling for Australia's top personal rate to be reduced to 30%, in line with the company rate.

In the Budget, Dr Cullen will announce some tax policy changes but they are likely to be modest, in some cases dubious and in others merely tax deferrals. So far Dr Cullen has ignored the recommendations of the 2001 McLeod Tax Review to adopt a lower, flatter tax scale. If opposition parties pick them up, tax policy could be a major point of difference in the election campaign.*

*First published in *The Otago Daily Times* on 6 May 2005.

Taxation in New Zealand: myth and reality

Some common arguments about taxation are based on incorrect assumptions – persistent beliefs with little basis in reality. One myth is that New Zealand is a low-taxing country. Another is the claim that the income tax burden falls disproportionately on middle-income earners and the poor.

In a recent study produced for the Business Roundtable, Personal Income Tax in New Zealand: Who Pays and Is Progressive Taxation Justified?, Sinclair Davidson, associate professor in the School of Economics and Finance at RMIT University in Melbourne, addressed three questions:

- Is New Zealand a high-tax or low-tax economy?
- Who pays the lion's share of tax in New Zealand?
- How do arguments for a progressive tax scale measure up?

In answering the first question, Dr Davidson commented that tax comparisons among OECD member countries can be misleading. The OECD consists of 30 economies. Some are large with low tax rates, but many are small with high tax rates. Using unweighted averages means the average tax-to-GDP (gross domestic product) ratio is biased upwards. The unweighted OECD ratio of tax to GDP was 36.3 percent in 2002. Compared to New Zealand's ratio of 34.9 percent, it might be concluded that New Zealand is a relatively low-taxing country.

However, when the average OECD ratio is weighted for population and GDP, a more accurate picture emerges. The average OECD tax take is 31.2 percent when weighted for GDP, while on a population-based weighting the average OECD tax take is 30.9 percent. New Zealand's 34.9 percent appears in a new light.

The difference in tax burdens is even bigger if the comparison is restricted to English-speaking nations. On an unweighted basis the average tax take of these countries is 31.8 percent. Based on a GDP weighting the average falls to 28.3 percent; on a population basis the average is 28.7 percent.

These comparisons make it clear that New Zealand is not a low-tax economy compared with non-European economies. High tax burdens are one reason why many European economies are struggling to grow.

In addition to the overall burden being high, New Zealand's top marginal tax rate cuts in very quickly at an income level of 1.2 times average per GDP. This compares unfavourably with the United States at 8.5 times per capita GDP and Singapore at 9.5 times per capita GDP.

Dr Davidson next examined whether the facts support a perception that the so-called 'rich' do not pay their fair share. Treasury data show the tax burden is actually concentrated in households in the top half of the income distribution.

In 2004–05 the top 2.58 percent of taxpayers paid 24.07 percent of personal income tax. These taxpayers pay 9.33 times more in tax than their population share. The top 10 percent of households pay almost as much in tax as the next decile earns in income. In comparison, between 40 and 60 percent of households receive more in government benefits than they pay in tax. People earning less than $40,000, who make up 79 percent of the taxpaying population, only pay 33 percent of all income tax.

Many have come to believe that progressive taxation (a graduated tax scale) means 'fair' taxation. Finance minister Dr Michael Cullen, for example, has framed the argument against flatter taxes by saying that "it really is a matter of fairness." However, the 2001 Tax Review chaired by Rob McLeod noted that philosophical arguments can be made for and against both progressive and proportional tax systems, and that each can be described as 'fair.'

Dr Davidson finds arguments for progressive taxation to be unsatisfactory. In the end, any sense of fairness in a progressive system can only be arbitrary and will therefore always be controversial.

If 'fairness' is defined as proportional taxation, Dr Davidson's paper shows that New Zealand's system is not fair: higher income earners are paying far more than the proportion they earn. A pure flat or proportional tax would mean that a taxpayer who earned 5 times as much as another would pay 5 times as much tax – neither more nor less.

Higher income earners would gain with a flatter tax structure, although experience suggests they could end up paying much the same amount of tax as before because less effort would go into tax minimisation. Moreover, they would not be the only ones to gain. People would have a greater incentive to work to increase their income as they would not move into higher tax brackets, and the elimination of high marginal rates would boost economic growth, to the benefit of the community at large.

The 2001 Tax Review weighed up competing arguments and came down in favour of moves towards a lower, flatter tax structure. *The Economist* magazine reports this week that the idea of a flat tax has been adopted in several ex-Soviet Union countries and is being debated elsewhere. As its leader says, "The flat-tax idea is big enough and simple enough to be worth taking seriously."[*]

[*]First published in *The Otago Daily Times* on 22 April 2005.

Regulation of unlisted is unwarranted

In December 2003 the informal stock exchange Unlisted was established to provide a "cost-efficient, easy way for small to medium sized companies to trade their shares and to keep their shareholders informed." Unlisted is an internet-based security trading and information dissemination platform, enabling subscribing companies to post company announcements over a centralised website for free access by all, and to facilitate trading in those companies' various types of security (such as shares and convertible notes). It currently has 21 subscribed companies.

Last December commerce minister Margaret Wilson announced she intended to "declare Unlisted subject to the provisions of the Securities Market Act." Wilson has since been replaced by Pete Hodgson, who will decide in a few weeks whether Unlisted has to be a listed securities trader under the Act. This would bring extra costs and red tape for Unlisted and the companies dealing with it, and reduce its operational flexibility.

In her December letter, Wilson wrote that without regulation, the continued operation of Unlisted would be detrimental to the integrity and effectiveness of the securities markets in New Zealand, and to the confidence of investors. She set out four reasons. These related to the growing size of Unlisted, comparative international regulation, regulatory difference and arbitrage, and an alleged potential for confusion.

These arguments do not make a case for regulating Unlisted. The level of its business indicates, if anything, that it meets its clients' requirements in respect of confidence, effectiveness and integrity. If they were not sufficiently confident about such basic requirements, why would they deal with it?

Legislation in other reputable securities markets such as the United Kingdom permits operations such as Unlisted, and some have been set up.

Financial commentator Gareth Morgan has roundly condemned the planned changes. The Institute for Financial Professionals, Business New Zealand and the Business Roundtable all oppose greater regulation of Unlisted. Each of these groups has made the point that the operation of Unlisted is not 'unregulated.' It is subject to many statutory and common law requirements. In fact, international research cited by Victoria University's Institute for the Study of Competition and Regulation suggests the legal environment is among the most protective of investors in the world.

If Unlisted were forced to become a registered exchange with higher costs, many of its issuers would revert to informal methods of trading which were less satisfactory from their point of view, rather than list on New Zealand's only registered stock exchange, the New Zealand Exchange (NZX). There is

considerably more risk to shareholders in less formal share transfer practices than in dealing with Unlisted.

The minister's concern about problems for Unlisted clients appears to be based entirely on hypothetical situations. No evidence has been produced that there are any problems in reality – and the burden of proof should be on those advocating greater regulation.

Little notice appears to have been taken of the measures Unlisted has put in place to avoid confusion, such as disclaimers and requirements for brokers to obtain signed acknowledgements of its status from clients before executing transactions. Any notion that investors are not competent to read simple declarations of Unlisted's regulatory status begs the question as to why the law should regard them as competent to make investment decisions in general, whether on Unlisted or on the NZX. New Zealand cannot hope to have efficient capital markets if legislation is based on the assumption that investors cannot read and comprehend simple statements.

Business New Zealand chief executive Phil O'Reilly recently said Unlisted was working well for investors. "We're not aware of any confusion about the nature of its makeup. We think it does increase the depth and breadth of New Zealand capital markets, and it's particularly helpful for small to medium-sized businesses looking to list for the first time."

A review of the material supplied by the Ministry of Economic Development in response to an Official Information Act request confirms the Ministry has uncovered no evidence of any problem with investor confidence or with the integrity or effectiveness of securities markets in New Zealand.

It is well understood in the economic theory of regulation that state regulators and the firms they regulate have a common interest in raising the costs of services provided outside the regulator's purview. Regulatory policy makers are often captured by interested parties. In the current instance, these appear to be government regulators (domestic or international) and the NZX.

Legislation governing the New Zealand securities market was never designed to shelter the NZX from competition. Choice and competition in securities trading are important advantages for investors and important protections against inefficiency on the part of exchanges.

The Business Roundtable, along with other business groups, has strongly urged the government to resist the assumption that investors can best be protected by limiting their freedom of action. The status of Unlisted is not a 'problem' that the government needs to 'fix.'*

*First published in *The Otago Daily Times* on 1 April 2005.

Hui Taumata: a source of optimism

In 1984, Maori leaders and thinkers came together at the first Hui Taumata to share their dreams and ideas for the 20 years ahead. Last week's Hui Taumata was a celebration of what has been achieved, and a commitment to a stronger focus on economic development in the next two decades.

I attended the Hui Taumata along with the Business Roundtable chairman Rob McLeod, who is of Ngati Porou descent.

A programme of research and widespread discussion was summarised into three Stimulus Papers which provided the foundation for the exchange of ideas at the Hui. These papers and the meeting itself underlined very encouraging and forward-looking trends in Maori thinking about economic development.

There were three themes for the conference – Developing People, Developing Assets, and Developing Enterprise.

There was broad endorsement of the fact that what matters most for Maori development are the same things that matter most for the whole community: a strong economy, faster job creation, excellence in education and an end to passive welfare dependency and broken families.

Improving outcomes for Maori – as for all New Zealanders – depends ultimately on ongoing reforms of institutions and policies. A key institutional requirement for investment and growth is secure property rights. Maori and the business community have a common interest in promoting greater security of property rights in New Zealand. The foreshore and seabed debate is a property rights issue and Maori and business found themselves on the same side. New Zealand governments have often failed to respect established property rights. The Resource Management Act, electricity reforms, the Timberlands episode, and various regulatory measures affecting network industries are other cases in point.

There was also acceptance that improving Maori human capital, through workforce participation and better education, is more important than ownership of specific assets. A Stimulus Paper states: "By far the biggest earner for Maori, and the biggest contribution that Maori make to New Zealand's economy, is participation in the labour market."

It is encouraging that the emphasis is on both education and employment, rather than education alone. While no one denies the value of education, it is not a silver bullet for either individual or national prosperity, as is sometimes implied. Education in the former Soviet Union was often of a high standard; the country had many good scientists, engineers and technicians, yet it was an economic basket case.

Participation in the labour market is vital for Maori. The Hui Taumata steering committee was correct to note in a paper for the conference that:

Since 1991 [when the labour market was freed up with the Employment Contracts Act] Maori employment has been growing fairly steadily, with many of us who had been experiencing unemployment finding jobs, and other people choosing to come back into the workforce.

Especially for those with low skills, getting a first job, even at a low wage, is enormously important as a pathway to gaining experience, work habits and higher skills. It follows that the removal of obstacles to employment wherever feasible should be a priority for Maori and non-Maori alike.

Equally encouraging was the recognition that Treaty issues, while important as matters of justice, are largely separate from economic development. Treaty settlements will result in modest wealth redistribution, not the generalised wealth creation which must form the basis of future prosperity for Maori.

There was also a recognition at the Hui that the tribulations of national and tribal politics have too often held Maori back, and that Maori economic and social development would benefit from a greater emphasis on private enterprise, individual initiative and self-determination – tino rangatiratanga. While having distinctive features, Maori business enterprise is essentially part of the wider enterprise sector – improvements in Maori business practice will be best fostered by comprehensive engagement with the wider business sector and the adoption of the most successful business models within it.

Among Maoridom, as in the wider community, there is growing awareness that success in business should be publicised and applauded. It was refreshing to see young business entrepreneurs being celebrated by their peers during the Hui.

Major challenges that need to be faced up to were identified. These include: better governance of Maori organisations, the removal of obstacles to employment, more parental choice in education, strengthening whanau, and grasping the nettle of fragmented land title – perhaps by the establishment of a highly qualified task force to report on issues and solutions.

At the end of the three-day Hui, Rob McLeod noted that it had marked a significant transformation in Maori attitudes towards business and the economy, and a general desire for more freedom and less state involvement in Maori economic and social life.

The Hui Taumata was a source of much optimism and promise. What is now needed is action along the lines that the Hui mapped out.*

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*First published in *The Otago Daily Times* on 11 March 2005.

Budget Policy Statement shows need for credible growth strategy

Each year the government issues a Budget Policy Statement (BPS) that contains its long-term objectives for fiscal policy, its broad strategic priorities for the next Budget, and its aggregate fiscal intentions for the next three financial years.

Recently the 2005 BPS was published. A pleasing feature is that it unequivocally states:

> New Zealand's recent growth performance can be attributed to past structural reforms that began in the mid-1980s, which have resulted in a trend increase in New Zealand's growth rate since the early 1990s . . . a more flexible economy better able to absorb adverse shocks and take advantage of favourable shocks, and sound macroeconomic policy settings.

Given this acknowledgement, the government's repeated references to "the failed policies of the past" can now only be taken as misleading political rhetoric.

However, when it comes to present and future policies and their effect on growth, taxpayers have less reason for confidence. There is no basis in the BPS for believing that the budget 'tax-and-spend' strategy will contribute positively to the government's growth objectives. On the contrary, a solid case can be made that it is more likely to impair prosperity and thereby put other goals at risk.

The government has consistently stated that returning New Zealand to the top half of the OECD per capita income ladder is its "top priority" goal. This was reiterated as recently as December 2004 when it stated in its social policy document *Opportunity for all New Zealanders*: "The Government's economic objective is to return New Zealand's GDP per capita to the top half of the OECD rankings." It is therefore very puzzling to note that the BPS is completely silent about this objective, against which the government has to date been happy to measure its performance.

In 2002 the minister of finance stated that it would be clear within the next couple of years (ie by mid-2004) whether New Zealand was on the right track to achieve its "top priority" goal. It is now apparent that it is not. The December Economic and Fiscal Update 2004 (DEFU) projected that after this fiscal year, New Zealand's growth in GDP per capita will average only 1.9 percent per annum through to 2009. This is well below the post-1993 average of 2.5 percent per annum. Professional forecasters are sticking with the widespread view that the underlying trend in labour productivity growth going forward is around 1.5 percent per annum. These growth rates are well below those needed to reach the

level of incomes of countries in the top half of the OECD within any reasonable period of time (say a decade or two).

It is equally clear that the government is not on track to achieve the minister of finance's alternative goal of sustained GDP growth of 4 percent per annum. The BPS projects real GDP growth to be in the 2.4–3.0 percent range in 2006–2009 (the average since 1993 has been 3.7 percent per annum). In contrast, the BPS projects Australia's GDP growth rate to be in the 3.3–3.5 percent range and our trading partners' average GDP growth rate to be in the 3.4–3.5 percent range.

The BPS has two fundamental problems. One is the absence of any analysis of the likely effect of additional tax revenue and spending on the growth objectives. The other is the failure to put forward any principles for assessing whether new spending is justified or and to evaluate whether existing spending is achieving desired results.

High and growing levels of government spending are a major drag on the economy. The government has been spending a large proportion of the 'growth dividend' and there is no analysis in the BPS to suggest that it is achieving value for money. A far better growth strategy would be to cut taxes and let taxpayers make spending decisions for themselves. The Business Roundtable has recommended getting all income tax rates – personal and company – down to a maximum of 25 percent. At an estimated annual revenue cost of $3.6 billion, this could be easily managed over a few years and make New Zealand a far more attractive place to work and invest.

The Business Roundtable recently published *Restraining Leviathan* by Dr Bryce Wilkinson which promoted a strengthening of the Fiscal Responsibility Act to curb unjustified expenditure. A central proposal was a rule to limit growth in government spending to population growth plus inflation, unless taxpayers authorised higher limits in a referendum. Finance minister Michael Cullen dismissed the proposal as "ideological," apparently unaware that the rule – or variants of it – is in place in a number of countries and many US states.

The government has also shown no interest in a Regulatory Responsibility Act to check and reverse the growth in regulation which is making business operation in New Zealand more difficult and holding back growth. This is favoured by several business organisations.

Despite the current economic buoyancy, it is plain that the government's own growth objectives are not being met. Its policies are leading to a deceleration, not an acceleration, of growth. A more credible growth strategy is badly needed.*

*First published in *The Otago Daily Times* on 25 February 2005.

Roderick Deane on corporate governance

Not many people achieve mastery in both business and economics – they are very different vocations requiring different sets of skills. Some understanding of economics helps in running a business, but it is not a core skill set. Similarly, what people learn from running a business doesn't help a great deal in formulating economic policy. A rare example of a person highly qualified in both fields is Roderick Deane, who was recently named Chairperson of the Year.

Deane is chairman of Telecom, Fletcher Building, ANZ National Bank, New Zealand Seed Fund, Te Papa, Wellington's City Gallery Foundation, and a board member and patron of the IHC. He is a past chairman of the State Services Commission and in the first part of his career was an expert in monetary policy. He is a member and past vice-chairman of the New Zealand Business Roundtable. He is not afraid to speak out on public policy – in 2004 he expressed his fear that a plethora of re-regulation would bring "reduced flexibility and reduced adaptability for private sector firms."

Speaking about his chairmanships to *Wellington Today* recently, Deane said that "the reason I do these jobs is because I find them interesting in an intellectual way, and indeed fascinating. It's great fun working with other people and it's great fun doing things that benefit customers and other people."

Deane says being a chairman means "encouraging the board to work with management closely to develop a vision for the organisation, to build a group of strategies to deliver that vision, to deliver on that vision, to ensure that we have the right people in place to effect that, including having the right chief executive." The most important role is to have a good relationship with the chief executive and to ensure the relationships between the board and management work well, he says.

Aside from his role as chairman of Telecom, Deane says his most rewarding experience was as chairman of IHC in the early 1990s, developing and implementing strategies to assist the intellectually handicapped make the transition out of fulltime care. That role was also one of the most challenging: "We were in financial stress and were facing great change in the way intellectually handicapped people were being integrated into the community."

Deane's corporate career has spanned the course of many changes in the business environment. "We've opened up New Zealand's trading borders hugely in the last 15 years with the reduction of tariffs, removal of import licensing and exchange controls."

Having been at the forefront of many of New Zealand's most influential companies for nearly two decades, Deane is well-qualified to gauge the state of corporate governance in New Zealand. He does not subscribe to the belief that

New Zealand's companies are poorly led, pointing out that this is inconsistent with EVA (economic value added) statistics and the economy's strong growth. "I think there's strong leadership in all the companies that I'm associated with, and when I think about the chief executives I work with, John Anderson at ANZ National Bank, Ralph Waters at Fletcher Building, Theresa Gattung at Telecom, they're fine leaders, and they've got lots of drive and energy and ideas, and their companies are growing and doing well." Where there is a gap, he believes, is in "business managers who are good general managers across a whole spectrum of activities." However, he is optimistic about the future. "I think New Zealand has born and bred a lot more [managers] who can cope in an unregulated world."

Deane believes the core challenge facing New Zealand boards is the increasing amount of regulation. He points as examples to new regulations affecting the capital and securities markets, changes in accounting standards, the Commerce Act, the labour relations area, specific industry regulation and Kyoto Protocol requirements. "There's been a huge increase in detailed regulatory interventions by this Government which are really just starting to accumulate, and I think have become burdensome for boards."

Some new regulations were created after corporate governance scandals in the United States and Australia. Deane believes, though, that there was an over-reaction, especially in terms of the detailed controls that were put in place. He considers New Zealand standards are in very good order. He has rarely encountered fraud or dishonesty in New Zealand, for which he credits education and basic social values rather than regulation.

"At the end of the day, you can't legislate for honesty. Integrity is something which derives from people's value sets and that's not found in a legislative framework."

Of the new regulatory initiatives, Deane says, "in many cases these initiatives are well-meant but they become so overpoweringly detailed they become a distraction from getting on with commercial life," and "it's the business world after all that generates growth." Deane's message is simple: companies should be given greater freedom to manage their own affairs, and economic freedom and prosperity are closely linked.*

*First published in *The Otago Daily Times* on 11 February 2005.

In economics everything takes time

Changes to an economy seldom happen overnight. But, just like Rachel Hunter's hair, they do happen. Developments just take a long time to filter through.

It is human nature to focus on the short term. When the economy is going well many of us hope for instant improvements to our living conditions, such as higher wages. Likewise, when public policy changes are instituted, it is natural to ask: how am I affected today?

In economics, little happens in the blink of an eye. A policy change will result in reverberations that might not be apparent for several years. Commentator John Hyde is a former Liberal member of Australia's parliament. In a 2001 speech titled 'We set up the economic conditions after 2010 today,' Hyde argued: "The rewards of sound economic policy, particularly policy affecting investment, may lag by as much as a decade." In Australia's case, he said, it was not until after the recession of 1991 "that we began really to enjoy the benefits of what was done in the 1980s."

On this side of the Tasman there were complaints during the 1980s and early 1990s that there were no immediate benefits from the economic reforms of the Lange-Douglas and Bolger-Richardson governments. This expectation of instant nirvana was naïve and unrealistic. The country's economy was very sick. It was characterised by unproductive, uncompetitive industries that survived because they were protected by the government. Because economic policies had been heading in the wrong direction for decades, the turnaround could be no five-minute affair.

Commentators who based their opinions on the absence of on-the-spot results were short-sighted. As finance minister Dr Michael Cullen acknowledged in the December 2004 economic and fiscal update, those 20 year-old reforms should be credited for the economic successes of today.

There are many lags in an economy. Consider skill levels. One indication of a population's skill level is the rate of participation in tertiary education. In the 1980s this was relatively low. Thanks in no small part to the reforms of the early 1990s, it is now relatively high. However, skilled new entrants remain a small proportion of the overall workforce. The average qualification level of the workforce will only rise significantly over the next decade or two. This will benefit the economy regardless of whether other government policies are good or bad.

Wages are another area where a short-term view is often taken. When the Employment Contracts Act was introduced in 1991 there were complaints that it did not produce instant improvements in labour productivity, and that wages did not rise across-the-board. At that time companies were busy absorbing the

jobless into the lower end of the workforce. An artificial, universal wage rise would have reduced employers' ability to hire unemployed workers just as they were gaining a foothold in the labour market.

As the rate of unemployment has come down, wages have moved up in areas of high demand for labour. The difficulty of finding skilled and unskilled workers is the highest it has been since mid-1974. According to the New Zealand Institute of Economic Research, "this points to future strong growth in wages." The Institute says wages can be correlated to the difficulty of finding skilled labour two years earlier.

These lags appear to vex some observers. *Listener* deputy editor Tim Watkin wrote recently that workers were losing ground. He believed "the pay packets of most New Zealanders are not reflecting the boom." This argument ignores the fact that wages reflect supply and demand. Where notable shortages occur in the economy, pay increases occur faster. This does not just happen in so-called 'high skill' sectors. Help desk operators, mechanics, scientists, customer services managers and engineers were among those who had the highest wage growth of 2004, with each group enjoying increases of more than five percent.

Because economic developments take time to occur, it is easy to become complacent about our country's overall performance. However, policy makers should be sensitive to the fact that New Zealand is losing ground in annual measures of economic freedom. The Heritage Foundation/ *Wall Street Journal* Index of Economic Freedom shows that, over the last nine years, countries that have done the most to improve their economic freedom scores have in general experienced the highest rates of economic growth. New Zealand's overall score in the 2005 index was the same as in 2004. However, the country's ranking slipped from third last year to fifth-equal in 2005 – behind Hong Kong, Singapore, Luxembourg and Estonia.

Standing still does not mean that the sky falls in, or that the economy suddenly crumbles. It means that we do not perform as well as we could. Lower rates of growth in productivity mean lower wages compared to our cousins in Australia, and less money to spend on education and health. Too many recent policy changes have been anti-business and anti-growth. The fall-out from these moves will not happen quickly, but it will happen.*

*First published in *The Otago Daily Times* on 28 January 2005.

A deficit of understanding

The balance between a country's exports and imports of goods and services is known as its trade balance. This balance, combined with the balance of inward and outward investment income and other current transfers, makes up its current account surplus or deficit.

New Zealand's current account deficit grew to record levels in the September quarter. Statistics New Zealand said the deficit came to a seasonally adjusted $3.09 billion in the three months to September, the largest quarterly figure since records began in 1987. The annualised deficit for the 12 months to September was $8.25 billion, also a record. Government statistician Brian Pink said the current account deficit represented 5.8 percent of gross domestic product, up from 4.8 percent in the same period in 2003. "The increase in the deficit was due to a fall in goods exports, combined with an increase in income earned from foreign investment in New Zealand," Pink said in a statement.

Some observers assume that the current account deficit is a cause for alarm and government intervention. This is incorrect. A greater cause for concern is that such primitive economic commentary is widespread.

Neither current account surpluses nor deficits should be seen as particularly good or bad in themselves. Consider the imbalance of payments between the North and South Islands. Such an imbalance surely exists, yet nobody really knows or cares what it looks like. There are no claims that the accumulated stock of assets and liabilities is harming people in either island, and there are no calls for the government to 'fix the problem.'

The story is no different when it comes to trade and payments between New Zealand and other countries. As the chairman of the economics department at George Mason University Donald Boudreaux recently said, "Classifying the world's producers and consumers according to the issuer of their passports creates an illusion of relevance out of an utterly irrelevant happenstance."

Arriving at a particular current account balance should not be the object or ultimate goal of public policy. There could be a genuine cause for apprehension if the government were distorting the situation by running large budget deficits, or if it were involved in net foreign borrowing. However, neither is the case at present.

An Asian-style financial melt-down is sometimes presented as a doomsday result of prolonged current account deficits. This has little relevance to the New Zealand context. One reason is that most Asian countries had fixed exchange rates, determined by governments rather than market participants. Another is that the New Zealand banking system is much stronger than that of Asia before

that region's bust. There is no evidence banks have left themselves open to significant exposure on money lent in New Zealand.

Debt to foreigners is created when commercial transactions involve borrowing from abroad. Therefore the current account deficit reflects the enthusiasm foreigners have for investing in New Zealand, and their confidence in our economy. To the extent that investor confidence drives the deficit, it should cause no concern. Opportunities for mutually advantageous trade and investment are what matter, and the greater the number of such opportunities, the better. Lenders to New Zealand are not naïve. They judge their exposure. If they become concerned, they will mark up the interest on loans, or mark down the New Zealand dollar.

Ill-informed arm-waving about the current account deficit raises the spectre of solutions to problems that do not exist. Because the current account deficit also represents the difference between domestic savings and investment, arguments become louder for the government to intervene to force up savings. The latest suggestion is compulsory workplace superannuation. There is no principled reason to switch to a compulsory system, and there is no evidence that voluntary arrangements are failing. The most exhaustive attempt to assemble evidence on New Zealand's savings level and trends was contained in a 2002 paper by Treasury officials who concluded that, after making adjustments for inflation, there has been no apparent downward trend in the level of private savings in New Zealand. They also found national saving rates could be much higher than suggested by conventional measures. The vast majority of New Zealanders make sensible decisions about what they will spend today and what they will put aside for spending tomorrow.

Another unfortunate side-effect of excited rhetoric about the current account deficit is that it distracts attention from the areas where New Zealand really should be striving for improvement. For several years this country has slipped in global competitiveness surveys. While our performance continues to be relatively strong – a testament to the forward-looking reforms of the 1980s and early 1990s – other countries are doing better.

It is almost 10 years since New Zealand's index rating peaked in the Economic Freedom of the World Annual Report, co-published locally by the New Zealand Business Roundtable. Factors behind our slide include increased government spending (which pushes up domestic costs and prices and hurts exporters), anti-growth measures such as the changes to the Employment Relations Act and the 2004 budget redistributive spending plans, and increased regulatory costs. These are matters that New Zealand's policy makers should be focused on – not the status of the current external balance.*

*First published in *The Otago Daily Times* on 14 January 2005.

Part IV

2004

Reducing barriers to investment in infrastructure

In 2004 there was a lot of talk about infrastructure. Among other things we had the government's infrastructure stocktake and the formation of an infrastructure lobby group.

Typically, infrastructure industries are taken to include roads, railways, electricity, water, gas, telecommunications, ports and airports. The definition of infrastructure favoured by the government, however, seems to be 'everything that the state takes responsibility for.' Listing infrastructure spending recently, finance minister Michael Cullen included prisons, defence force equipment, replacement of hospitals, building new schools, recapitalising a national airline, installing new electricity generating capacity, upgrading the electricity transmission grid, road building and even "saving rail."

Defence and prisons are genuine 'public good' activities for which the state must be responsible (although there is no reason why the private sector can't manage prisons under contract). By contrast, many infrastructure industries, like ports and airports, can be run as normal businesses.

In May 2004 the Ministry of Economic Development released a nationwide infrastructure stocktake prepared by PricewaterhouseCoopers. The main areas of concern were security of electricity supply, investment in electricity transmission, road congestion, water allocation problems, and water quality problems. These sectors – electricity, roading and water – have one obvious thing in common: they are all government-dominated. Notably absent from the problem list are the five infrastructure industries dominated by the private sector: telecommunications, gas, railways, airports and ports.

Contrast the situation today with that in the early 1980s. The major problem areas then included telecommunications, ports and railways, all of which were publicly owned. In 1987 there were 15,000 people waiting on average 6 weeks or more to have a phone connected. Our ports and railways were a disgrace. Governments of the time undertook an extensive programme of deregulation, corporatisation and privatisation and the problems of capacity shortages and poor performance have, by and large, gone away.

Few, if any, people complain about under-capacity in telecommunications today. In ports, the only problem is that the job has not been completed: local government ownership has impeded industry rationalisation. The largely privately owned airports like Auckland and Wellington international airports have been stellar performers for shareholders and travellers alike. Likewise, the gas industry is largely privately owned and performing well, although the government seems bent on fixing a problem that doesn't exist.

Rail has been controversial again in recent years. However, for all its faults, Tranz Rail (now Toll) has done a better job than when the business was under government control. The company has at least achieved a better, if inadequate, return on capital. Deregulation of road and rail transport has delivered huge benefits to users and to New Zealand's international competitiveness.

Much has been said and written about public-private partnerships (PPPs). PPPs have been adopted in over 140 countries, New Zealand amongst them. They can be very successful. Contracting out, for example, has been a consistent success story for local government in New Zealand, with cost savings of 10 to 30 percent commonly cited. Experience from the United Kingdom shows how to structure PPPs and where they work best. A critical issue is whether the provider's performance can be adequately defined and measured. Where it can be – as, for example, in the case of prisons – private providers can offer considerable advantages by bringing lower costs and/or more innovative services. However, PPPs can also become dodgy and corrupt where proper processes are not followed or where performance cannot be adequately measured.

Outright privatisation is often a better policy. Why go for a convoluted second-best solution when full privatisation is feasible and known to deliver the goods? Isn't it better that governments focus on what they can do best – setting the rules, ensuring the provision of public goods, and providing a welfare safety net – and allow the private sector to focus on running commercial businesses?

Auckland's congestion problem is a national disgrace. As far back as 1993 the Business Roundtable released a major study on options for roading reform in New Zealand. The solutions advocated were not radical or complex. They are simple and are now well tried around the world. Firstly, build more road capacity where it is economically justified; secondly, face users with the true costs of services by introducing economically efficient pricing; and thirdly, put the management and operation of roads on a similar basis to other utilities like telecommunications, and extricate it from political control.

Other countries are getting on with privatisation. New Zealand is going in the opposite direction, with over $5 billion of assets renationalised in the last few years. We are the only country in the OECD with a blanket ban on privatising SOEs. This is despite the overwhelming evidence that the private sector is better, on average and over time, at running commercial businesses than the public sector.

In relation to infrastructure, the OECD has recommended the New Zealand government drops its ideological opposition to further privatisation, focuses on reform of roading management rather than on rail or public transport, and addresses the problems of (government-induced) uncertainty, creeping regulation and the impact of the RMA. Most of the changes required to promote better

infrastructure can be summarised simply: more private enterprise and less government.*

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Multinational companies don't rule the world

According to *Guardian* columnist George Monbiot, "the struggle between people and corporations will be the defining battle of the twenty-first century. If the corporations win, liberal democracy will come to an end. The great social democratic institutions which have defended the weak against the strong ... will be toppled."

There is much evidence to support the conclusion of *Financial Times* associate editor and chief economics commentator Martin Wolf that "the radical critics of contemporary global economic integration detest corporations." Wolf – who delivered the New Zealand Business Roundtable's 2004 Sir Ronald Trotter Lecture on the role of the state in an era of globalisation – examines claims about corporations in his book *Why Globalisation Works*.

The first claim he scrutinises is that corporations are more powerful than most countries. In 2000, the left-of-centre Institute for Policy Studies in Washington, DC published an influential paper arguing that 51 of the world's 100 biggest economies are corporations. Wolf wonders "whether this is true and, if so, whether it matters." He finds the answers are no, and no. The Institute for Policy Studies confused gross sales with GDP – it should have looked at companies' value added rather than sales. In 2000, for example, the sales of General Motors were $185 billion, but its value added was only $42 billion.

Even this exaggerates the power of multinational corporations. The US economy is 156 times bigger than the biggest corporation in the world. Economic activity in advanced countries dwarfs those of the largest corporations. In 2000 the top 10 multinationals generated 0.9 percent of world GDP, about as much as South Korea. Companies differ from countries because they cannot force their customers to buy from them. Countries have coercive control over territory and the ability to force people to pay taxes.

The second proposition Wolf examines is that brands give companies control over customers. The staunchest proponent of this argument is *No Logo* author Naomi Klein. Her beliefs, says Wolf, are based on the belief that "corporations do not compete, but control; they are not subservient to customers, but coerce them," through the power of the brand. This is the reverse of reality. Brands make companies susceptible to public opinion. Companies will go to great lengths to protect the value of their brand in the eyes of customers. Another of Klein's arguments – that the performance of multinational companies is due to brands – is also flawed. The top multinational company in 2000 by value added was Exxon Mobil. Its value lies not in its brand, but its organisational capacities.

The third and most important economic charge, by far, is that multinationals exploit poor countries and workers. Economic life is about beneficial mutual

'exploitation.' Wolf believes the difficulty facing most poor countries is that they are not being 'exploited' enough. "It is right to say that transnational companies exploit their Chinese workers in the hope of making profits. It is equally right to say that Chinese workers are exploiting transnationals in the (almost universally fulfilled) hope of obtaining higher pay, better training and more opportunities than would otherwise be available to them." The evidence that multinational companies generally pay more – and treat their workers better – than local companies is overwhelming. As Wolf points out, they can do so because their superior know-how makes them more efficient – that is why these companies have become multinationals in the first place.

Another claim, made by unions in wealthy countries – notably the United States, but also New Zealand – is that the export of capital forces workers to accept lower wages or lose their jobs. Several unsuccessful US presidential candidates vowed an end to 'outsourcing' – the exporting of jobs to nations with lower labour costs.

In reality, most investment from the United States goes to high-income countries with wages close to – or even higher than – US wages. There is no connection between microeconomic changes such as labour-intensive investment in developing nations and overall employment. Wolf concludes that investment abroad "simultaneously destroys and creates jobs." He does, however, find that foreign investment has weakened the grip of labour unions, partly because companies have an additional opportunity of exit.

The final allegation made against corporations is that they control states and subvert democracy. George Monbiot sees the corporation as a bastion of unaccountable power that dominates the political process. The bottom line is that corporations have influence, but not decisive power. There are many other forces with influence in contemporary democracies, from churches, to NGOs, to labour unions, to academia. The fear that democracy will founder under the assault of corporate interests is widely exaggerated.

Martin Wolf argues that, "Perhaps the core faith of globalisation's critics is the power and the malevolence of the corporation. This is their Satan." It is right to be on guard against the power of all special interests. It is wrong, however, to assume that any one group dominates.*

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Key issues for Maori are also those of wider society

Maori business enterprise is flourishing. Some research has suggested that in recent years more Maori, as a percentage of the working age population, have started new businesses than non-Maori, and that Maori have been creating firms at a faster rate than the overall firm-creation rate in Australia, the United Kingdom and the United States.

This should be no surprise. Maori quickly adopted the skills, technology and connections with external markets that the early British settlers brought with them. As minister of Maori affairs Parekura Horomia said earlier this year, making money isn't un-Maori, and mana and money can go together.

Maori commercial achievement extends to the highest levels of New Zealand business. The Business Roundtable chairman Rob McLeod is of Ngati Porou descent.

A good case can be made that greater involvement in business and less in politics would benefit Maori.

There are really only three ways that people can get what they want in life: through cooperative efforts in families, clubs and voluntary associations; through the marketplace; and through politics. Of these, politics is the most complex, uncertain and often costly route.

As a political minority, Maori are inherently disadvantaged in the game of politics. Politics is about numbers and voting power. Over the years Maori have had plenty of reasons to distrust the political process and governments.

Interestingly, the business sector also often finds itself in a minority position when it comes to politics. Business has little voting power. At the local government level we frequently see unjustifiable rate burdens placed on businesses because residential ratepayers have greater voting clout.

It is thus no accident that there has been an alignment of business and Maori views on a range of public policy issues. Common themes have been the protection of the rule of law, respect for property rights, and the dismantling of state monopolies in favour of individual choice and competition. Many business and Maori organisations were united in opposing the abolition of appeals to the Privy Council, a body that was seen as detached from local politics. The foreshore and seabed debate is essentially a property rights issue; the Business Roundtable and groups like the Treaty Tribes Coalition took the same position, namely that the validity of claims should have been a matter for the courts to determine, at least in the first instance. We were supported by Maori groups in advocating the dismantling of monopoly producer boards. Periodically I compare notes with

Paul Morgan of the Federation of Maori Authorities and I am always struck by the overlap of issues on our work programmes.

Treaty Negotiations Minister Doug Graham described settlements creating an 'economic base' for Maori development, and the term is still frequently used. While settlements are obviously of some material benefit, as well as an acknowledgement of past wrongs, this proposition is conceptually and empirically mistaken. It creates confusion and false expectations.

By far the largest settlement to date is the fisheries settlement. In present-day terms, this is worth some $800 million. If it were distributed equally to all Maori, the sum involved would be around $2000 a head. Contrast this amount with the earnings of a very low-skilled Maori over a working lifetime. Someone on a wage of, say, $25,000 a year for the next 40 years would earn a total of $1 million. This is equivalent to a lump sum of almost $500,000 today. By comparison with this return from gainful employment, $2000 is clearly a drop in the bucket.

The chief judge of the Maori Land Court Joe Williams was on the wrong track when he argued Treaty of Waitangi settlements needed to be five times larger to address Maori poverty. If the fisheries settlement was worth $10,000 on average to Maori rather than $2000, it would still not make much difference to someone over their working lifetime. The sums just don't stack up, and wealth in the modern world is not about having capital endowments or ownership of natural resources. The 'economic base' idea is simply bad and misleading economics.

None of this detracts from the Treaty settlement process. Treaty settlements are largely in a category of their own. They are essentially about justice – an attempt to right the worst of past wrongs without creating new ones, and to avoid a grievance process that stretches on interminably. Settlements involve mana and spiritual matters as well as claims to resources, but in economic terms they are about redistribution, not wealth creation. The two should not be confused.

In terms of wealth creation – raising living standards – what matters for Maori are the same things that matter for the rest of the community – a strong economy, plenty of jobs, a high quality education system, and less welfare dependency.

A shift toward greater freedom and choice, private initiative and personal responsibility is part of the way forward for Maori and New Zealand society in general.*

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The case for lower taxes

Those following the debate about tax cuts should keep three points firmly in mind.

First, it is individuals who pay tax. Companies, trusts and other entities may pay tax in the first instance but all are owned by individuals who ultimately bear the burden.

Second, it is middle and higher income earners who pay the lion's share of tax. Those in the top 10% of incomes pay 44% of total income tax whereas those in the bottom 20% pay less than 2%. You can't cut tax much on those who pay very little.

Third, high levels of government spending and taxation slow an economy down. Most damaging to growth are the highest effective marginal tax rates (ie the tax payable on the next dollar of income), including the top 39 % personal rate.

To contribute to the government's 'top priority' goal of faster growth, taxes should be lower and flatter. This was the key recommendation of the government's 2001 Tax Review.

In a submission to that Review, the Business Roundtable suggested a medium-term goal of reducing all income taxes – personal and company – to 25% or below. Singapore is cutting its personal and company tax rates to 20% next year.

Finance minister Michael Cullen calls a policy like Singapore's "tax cuts for the rich." He is focused on income redistribution, not growth.

But countries like Singapore and Hong Kong owe much of their success to low-tax policies. Cutting taxes on those who pay taxes doesn't only benefit them. Economic growth is the surest route to all-round prosperity over time. High, progressive taxes are driven by envy, not a concern for the poor.

Progressive leader Jim Anderton has recently proposed cutting the company tax rate. He has been a slow learner, but people have to find truth in their own way.

However, he has learned only half the tax lesson. Cutting company tax by itself is not a great policy.

As Dr Cullen has pointed out, it would benefit mainly overseas shareholders in New Zealand companies. With New Zealand's system of dividend imputation, what matters for New Zealand shareholders is their personal tax rate. Many farmers and small business owners pay only personal tax and would not benefit from the Anderton proposal. In 2001, the Inland Revenue Department estimated that if the company tax rate were cut to Australia's 30 percent level, only 2 percent of companies would benefit by more than $10,000.

And why should those who operate through companies benefit and not those who do business as sole traders, partnerships or trusts?

However, Dr Cullen's response is also only half the story. His objection can be overcome by cutting personal rates at the same time. Moreover, reducing the tax rate paid by foreign investors would benefit New Zealanders as well by lowering the cost of capital (eg mortgage interest rates) and stimulating investment.

The government had an operating surplus of $7.4 billion in the year to June 2004 and is planning to spend a massive additional $14 billion of taxpayers' money over the next 3 years.

Its 2004 Budget package involves giving many middle income people family assistance and hitting the same people with high tax rates if they earn more. It would be far better to cut their taxes and focus assistance on genuinely low income families.

The Treasury has calculated that at an annual fiscal cost of $4.7 billion all income tax rates (personal and company) could be reduced to a top rate of 18% – below Singapore's. Given the state of the government's accounts, such a goal is eminently achievable over a few years.

Think what a difference that would make to enterprising New Zealanders and the country's economic outlook.*

*First published in *The Press* on 23 November 2004.

Competition vital for efficiency as savings debate continues

Finance minister Dr Michael Cullen sees New Zealanders' poor levels of savings as "one of the country's most serious long-term economic problems." Earlier this year he set up the Savings Product Working Group for advice on ways to increase work-based savings for retirement. The Group reported back in September, proposing all new workers be automatically enrolled in a savings scheme with an optional 'opt-out' clause. Employers would deduct employee savings using a special tax code. The savings would be forwarded to the tax department, which would send the funds through a central administrator to a designated provider.

The government is yet to formally consider the report, but Dr Cullen called the plan "a practical proposal" and announced he is "committed to seeing progress made on workplace savings in my 2005 budget."

Echoing Dr Cullen's concerns, the Savings Product Working Group claimed New Zealanders "lack confidence about how [to save]," and "put off difficult decisions and fall back on non-saving habits." It is paternalistic to suggest better judgments about savings will be made by politicians than by the individual savers who vote them into office. Further, the claim that New Zealanders do not save enough is dubious. The Tax Review 2001 examined available evidence and found "it was not clear to us that New Zealanders save too little." Although submitters disputed this conclusion, "none ... cited any supporting evidence other than a claimed consensus among relevant experts that there is a problem." The most exhaustive attempt to assemble evidence on New Zealand's savings level and trends is contained in a 2002 paper by Treasury officials Iris Claus and Grant Scobie. They concluded that, after making adjustments for inflation, there has been no apparent downward trend in the level of private savings in New Zealand and national saving rates could be much higher than suggested by conventional measures.

Just as there is no principled reason to switch to a compulsory system, there is no evidence that voluntary arrangements are failing. As in other areas, competition is vital to promote efficiency, including cost containment and innovation over time. Both employers and employees have incentives to enter into efficient, voluntary remuneration arrangements. Around half of large employers deduct employee contributions to workplace or retail superannuation or other savings schemes from their wages. Employees who value such arrangements are likely to be attracted to firms that offer them. If other firms believe that their ability to recruit and retain staff is adversely affected by the absence of workplace superannuation or deduction facilities they would be encouraged to put them in

place. People's preferences on many matters differ, as a casual survey of the range of vehicles in a workplace car park would illustrate.

Even where workplace arrangements are not available, employees can arrange so-called 'painless' ways of saving if they wish, through automatic payments and the like – 420,000 New Zealanders choose to belong to retail superannuation schemes.

Many potential members of the proposed compulsory scheme would be in debt. In their case, a strategy of paying off debt would almost certainly yield a higher return (and a better personal outcome) than putting money into a superannuation scheme. Also, it would be less risky.

A compulsory scheme would inevitably reflect political factors, lobbying by interested parties, information problems and weak incentives. Every official review of superannuation arrangements conducted in the last 25 years has rejected the introduction of compulsory superannuation. Compelling employers to provide workplace superannuation, employees to contribute (even for a limited period), or both, would involve an unjustified intrusion into people's lives. In fact, the compulsory scheme outlined in the Working Group's report, if implemented, may well prove to be a Trojan horse for a compulsory scheme along the lines of the New Zealand First-promoted scheme that was overwhelmingly rejected by New Zealanders in a 1997 referendum.

The proposal, if implemented, is likely to put at risk existing workplace superannuation schemes, be excessively costly and impose higher compliance costs on employers. Superannuation arrangements, other than the safety net provided by New Zealand Superannuation (NZS) and the benefit system, should be a matter of personal responsibility and should be voluntary for employers, employees and other people.

Policy on superannuation should focus on lifting the rate of economic growth, reducing the cost of NZS over time below the levels projected on current parameters (eg by increasing the eligibility age for future retirees), and reducing regulatory burdens for all superannuation and saving schemes.

Voluntary arrangements provide the only effective means of ensuring that any generic workplace superannuation scheme that is developed is efficient. Employers and employees should continue to be permitted to agree voluntarily on pay and conditions of work, including whether to provide workplace superannuation.*

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Learning a lesson in welfare from the United States

Moving people off welfare and into work builds self-esteem and independence while improving the productive capacity of the economy. New Zealand can learn much from nations that have successfully reduced welfare rolls. The United States is a stand-out case in the last decade.

By the early 1990s the number of Americans on welfare had reached an all-time high. There was growing concern about increased welfare and the consequences for children of welfare dependency and poverty. Existing financial incentives were having a limited effect on people's decisions to work. The competencies, attitudes and confidence of many of those on welfare were regarded as inadequate.

Policy makers sought alternative measures. The 1996 welfare reforms created an obligation for work and emphasised measures that directly promoted and supported working.

Under Bill Clinton's presidency, the 1996 Personal Responsibility and Work Opportunity Reconciliation Act created the Temporary Assistance for Needy Families (TANF) programme. The Domestic Purposes Benefit is the New Zealand equivalent.

States were provided financial incentives to run mandatory, work-focused welfare programmes. Major and rapid changes were made to their welfare systems. They focused on work-first programmes which emphasised rapid attachment to the labour force, with less emphasis on skills training and education. More stringent work requirements were introduced with narrower exemptions, and work-related activities such as job searching were required. The financial rewards from work were increased. Welfare recipients could keep more of their welfare payments when employed, subsidies for child-care and transportation were increased, and tax credits and tax rates were changed. Tougher sanctions were imposed on those who didn't follow programme rules and maximum time periods for receiving welfare were set. Welfare administration was improved. Job search facilities were provided, strict performance measures were imposed on administrators and the temporary nature of assistance was strongly communicated to applicants.

The result was great progress. The welfare caseload in the TANF programme has been cut in half. Among disadvantaged single mothers who had the greatest tendency to become long-term welfare dependents, the employment rate has soared by between 50 and 100 percent. Today, 2.9 million fewer children live in poverty than in 1995.

The reforms were less successful in moving long-term unemployed off welfare and failed to make all former beneficiaries fully self-sufficient (for example, some still received child-care subsidies). Individuals who were still on welfare rolls after four years were found to have less education, fewer basic skills, less previous job experience, and a longer history of welfare receipt than people who had left welfare in the first year or two.

Critics have suggested the strong economy is the real reason behind welfare roll declines. However, former Director of the Congressional Budget Office Dr June O'Neill concluded that from 1996 to 1999, policy changes accounted for approximately three-quarters of the increase in employment, with economic conditions accounting for the rest.

Another criticism is that many mothers leave welfare but do not work regularly. Welfare reforms inevitably involve difficult trade-offs, and one of the most challenging is that greater hardship for some could well be a cost of reducing the likelihood that many others will become dependent on welfare.

The reforms did not reduce the direct cost of welfare. Despite the massive drop in welfare rolls the federal government is spending $1 billion a year more than was spent by state and federal governments before the reforms. Saving money, at least in the short term, was not seen as the main goal.

The US experience shows reforms need to be consistent. Work requirements should be present across all major welfare programmes to discourage people switching programmes to avoid work requirements. Minimum wage policies may limit the number of jobs available to people trying to move off welfare and should be considered in the broader context of welfare reform. New Zealand's system of family tax credits should avoid excessive disincentives to work. Education policy should focus on accessible and flexible training for those who move into work and avoid providing an avenue to avoid work testing, while job subsidies should be kept on a small scale, with limited time frames and a focus on job-related activities.

A strong economy helps reduce welfare rolls by providing more job opportunities. A time of steady economic growth provides an ideal opportunity to strengthen incentives to seek and accept work.

It is important to note that although welfare reform is central to addressing the problem of the large number of New Zealanders dependent on benefits, it is only the third leg of a three-part strategy. The first leg must be to raise income levels and create new jobs through ensuring steady economic growth. The second leg is addressing the problems of marriage break-up, which substantially reduces income and other resources available to the custodial parent and his or her children. A new Business Roundtable book examines family issues.

After eight years, the evidence shows that the 1996 welfare reforms in the United States worked. There is now bipartisan support for them. New Zealand would do well to emulate the success of the Clinton administration in this area.*

*First published in *The Otago Daily Times* on 5 November 2004.

Australia endorses reform

The re-election of John Howard's Liberal coalition endorsed Australia's recent directions: two decades of reforms are working. After sliding to fifteenth among rich nations in gross domestic product per capita by 1990, Australia climbed back to eighth by 2002.

Australia's consistency sets it apart from this country. Although New Zealand and Australia both started reforms in the mid-1980s, New Zealand has only enjoyed one short burst of reform (under the Bolger/Richardson government) since. Across the Tasman, Paul Keating and John Howard continued the course originally set by Bob Hawke. The Organisation for Economic Cooperation and Development (OECD) recently said Australia's "commitment to reform ... is something that other countries could learn from."

To a considerable extent the Australian election was about the economy, which is performing well. Productivity improvements on both sides of the Tasman have significantly improved economic growth rates. But Australia has had the edge: whereas New Zealand has stabilised its fall in the international rankings of per capita incomes, Australia has climbed back into the top half of the OECD. Australia is the sixth lowest taxing OECD nation. The government can point to 13 years of expansion, the lowest sustained interest rates and level of unemployment, the best real wages growth for two decades, and the highest rate of productivity growth since the 1960s. The poorest 10 percent of households increased their wealth almost as much as the richest between 1996 and 2001; groups in between did even better.

There is an attitudinal difference between Australia and New Zealand. Australians talk proudly about their economy's stellar performance. Most understand that the explicit goal of reform is to increase rewards for hard work so that a nation can better compete globally. The rhetoric still occasionally heard in New Zealand about "failed policies" would be considered utterly out-of-date in Australia.

Australians have an appetite for more progress. The *Australian Financial Review* recently editorialised.

"The difference between maintaining current growth and slipping back to rates of two decades ago would be $135 billion of GDP in 10 years. This would fund an extra $12 billion of health and $8 billion of education spending. The link between robust economic growth and spending on social services is real; the $25 billion of budget surpluses over the next four years are a dividend that critics of growth and economics ignore."

Prime minister John Howard promoted a pro-growth approach while Mark Latham's Labor focused on redistribution. Where Mr Howard was pledging to

"push the boundaries out as far as possible on workplace relations reform," Mr Latham was promising greater regulation and a return to union privileges.

Howard intends to continue reforms at a gradual but steady pace. As well as industrial relations, he is keen to cut personal and company taxes, reduce incentives for people to become reliant on the welfare system, and sell the remaining government share of Telstra.

There will be some issues requiring senate support, but it appears that the Liberal Party and its allies may have the majority needed to pass controversial legislation.

There is still room for improvement. There was little or no attempt by either side during the campaign to make the case for reform in schools or hospitals. The AFR stated, "what we need is someone to champion reform of social institutions – as Paul Keating championed economic reform in the past – and to tell voters the truth: either we accept more reform, work harder and grow output faster, or we face stagnant living standards."

An element of the Australian election that has reverberated here is pork-barrel politics. The Liberal Party shifted gears during the campaign and announced spending measures worth around A$6 billion.

These handouts to constituencies were painted as 'dividends from a better-performing economy.' They were not pivotal to the election result. Bigger picture issues – notably involvement in Iraq and the direction of the economy – were far more important to voters.

Indeed, the Liberal vote began softening in key marginal seats in the aftermath of the spend-up announcements. They had provided Labor an opportunity to attack the government for being fiscally reckless, and diverted attention from the vote-winning economy.

It was only after the Liberals went back on message and – in the words of one observer – "got back onto the economy" that polling improved.

The size of the handouts was never massive – less than NZ$1 billion if scaled to New Zealand. Finance minister Michael Cullen's last Budget announced NZ$14 billion of *additional* spending over the next three years.

Compared to Australia's consistent reform path, New Zealand is treading water. This shows: average incomes in Australia are already some 30 percent higher than in New Zealand. There is a risk that the gap will widen.

During the campaign Australian Treasurer Peter Costello pointed out that the next economic miracle, if any, will come from the same place as the last one – an open and competitive economy, lower tariffs and flexible labour and capital markets. Australian voters listened. Hopefully policymakers on this side of the Tasman paid attention, too.*

*First published in *The Otago Daily Times* on 22 October 2004.

The case for a flat tax

Most of us accept that we should contribute to the cost of public goods and services such as the police. This occurs most obviously through taxation.

There are three basic ways taxes can be allocated among citizens. The first is a head or poll tax. This is a fixed exaction upon individuals of an amount that does not vary with income. The street cleaner and the banker pay the same level of tax.

The second form of taxation is a progressive tax: The rate of taxation increases as the amount of money subject to the tax increases. New Zealand's income tax is a progressive tax. The rate of tax applied to the first dollar of income is 15 percent whereas that applied to each dollar of income over $60,000 is 39 percent. The rate of tax could start at zero and rise to 100 percent, or higher.

The third option is a flat tax. The rate of tax is the same regardless of the amount of income earned. The street cleaner and the banker would pay the same rate of tax, say, 25 percent. The banker would still pay more total tax than the cleaner because he/she earns a higher income.

Head taxes are very unpopular. At first sight they may seem bizarre. Yet we accept a somewhat similar approach every day when we belong to a gym, society or club: membership generally means flat dues for everybody. Similarly, prices charged by supermarkets do not depend on the income of the shopper.

The head tax, however, runs into serious problems if the tax is more than trivial. If taxpayers earned little income relative to the level of the head tax, they would face severe hardship.

The government might decide to remit the head tax on people who do not earn a minimum level of income, but this would create problems. It would need to raise additional tax from other people to compensate for the revenue forgone. The head tax has gone out the window.

The relevant question then is whether a flat tax or progressive income tax is more desirable.

A flat tax is more robust than a progressive tax. It is relatively easy to set the rate of tax and calculate the amount of tax paid by each taxpayer with a flat tax. It does not matter whether income is earned through a company or superannuation fund, or as a fringe benefit. All income would be taxed at the flat rate. Because every taxpayer pays the same rate of tax, there is less scope for the level of tax payable by different groups to be altered simply for political reasons.

The progressive tax is more complicated. The government must decide which particular progressive tax scale it favours out of the vast number that could be

conjured up. This choice is a political question. There is no principle to resolve it objectively. Political debate over the shape of tax scales can be divisive.

Some people claim that an increase in the progressiveness of the tax scale is warranted on fairness grounds. There is no limit to such arguments. A little more progressivity is always said to be fair.

A move to a flatter tax scale is often seen as a sop to the rich. People on high incomes initially benefit more than those on low incomes. But over time higher productivity may make everyone better off. A progressive tax scale discourages productivity and adversely affects living standards more than an equivalent flat tax.

Richard Epstein, a leading legal scholar at the University of Chicago, spoke on the flat tax during a recent visit to New Zealand as a guest of the Business Roundtable. The shape of a progressive tax scale leads to what he called the Goldilocks problem. This is the futile search for a schedule of tax rates that is 'just right.'

If there is little difference between the bottom and top tax rates, what is the point of the additional complexity and costs entailed in implementing a progressive tax? On the other hand, if the tax scale is highly progressive, people who create wealth and jobs are encouraged to engage in wasteful tax avoidance activities and some might migrate to other countries.

As Professor Epstein pointed out, there is great reluctance in the United States to have progressive tax systems at the state level because, "the folks who live in California can happily relocate to Nevada with a lower tax base." Tax competition is a strong restraint on the level of taxes and the progressivity of tax scales. This is a relevant lesson for New Zealand.

A flat tax is generally better than a progressive one. Paying taxes may not be a pleasure for most of us, but it could become somewhat less painful for many New Zealanders if the recommendation of the 2001 Tax Review (which was headed by Business Roundtable chairman, Rob McLeod) that a flatter income tax system be implemented were adopted.*

*First published in *The Otago Daily Times* on 8 October 2004.

The fiscal responsibility act: a stocktake after ten years

Fiscal policy is an important part of government operations. Government spending at all levels adds up to around 40 percent of gross domestic product (GDP); it has a major impact on the economy.

The quality of fiscal policy deteriorated during the 1970s and '80s. Government spending mushroomed; the tax system became distorted and inefficient with, among other things, excessive reliance on income tax and a punitive top tax rate of 66 percent; and governments ran large deficits which resulted in a heavy debt burden and credit rating downgrades. The parlous state of the government's books was a factor in the economic crisis triggered by the 1984 election. The incoming Labour government did much to improve fiscal policy, especially through sound tax reforms, but it struggled to achieve fiscal discipline and bequeathed its successor a deficit problem that necessitated the spending measures of the 1991 budget. In response to this haphazard record, the architects of the Fiscal Responsibility Act (FRA) – notably finance minister Ruth Richardson – sought to bring a greater focus in annual budgets to issues of fiscal prudence and longer-term strategy.

It is the tenth anniversary of the passage of the Fiscal Responsibility Act. Ten years is a reasonable period of time to assess the strengths and the weaknesses of the legislation, and to consider possible improvements.

The FRA has required a focus on fiscal prudence that has paid dividends in the form of sustained operating surpluses, improvements in Crown net worth and, most recently, an AAA credit rating for Crown foreign currency debt by one rating agency. However, it has not been successful in constraining government spending and the aggregate tax burden. Governments in the 1990s failed to achieve their long-term objective of reducing spending below 30 percent of GDP and subsequent governments have lifted the target to 35 percent. Nor has the FRA imposed any meaningful discipline on the quality of government spending. Contrary to expectations, the FRA has not led to meaningful debate about the value for money of government spending and the link between budget policy and economic growth.

The current government has portrayed itself as a prudent economic manager. This claim is only plausible with respect to its record of maintaining operating surpluses and ongoing debt reductions. Its spending and taxing record has been profligate. The decision to lift the long-term objective for spending under the FRA to 35 percent of GDP effectively sought to appropriate another twentieth of national income for the public sector. In the 2004 budget the government announced additional spending plans totalling a massive $14 billion over the

next three years, mostly in forms that would be classified as unproductive. This strategy is inconsistent with the government's stated top priority of increasing the economy's growth rate.

It is quite feasible to envisage a reduction of total government spending in New Zealand from around 40 percent to 30 percent of GDP. In a study for the Business Roundtable, Winton Bates estimated that reducing the most ill-justified government spending by 10 percent could add 0.5 percent per annum to the growth rate for a 10–25 year period.

Since the FRA has been relatively ineffective in curbing government spending growth, an obvious question is whether more explicit disciplines could be introduced. Families are familiar with spending caps – governments need the same. Tax and expenditure limits have the merit of giving politicians extra protection against vested interest groups and may encourage decisions that are more closely aligned with the public interest. Hong Kong, Japan, the Netherlands, Spain, Sweden, Switzerland and the United States have had rules aimed at capping spending. So have many US, Australian and Canadian state governments. US experience suggests that tax and expenditure limits have been effective in constraining spending, and are conducive to economic growth.

Limitations can be self-imposed by a government, or alternatively decided or ratified through referenda. There is also a case for a super-majority requirement for tax increases, because of the risk that a simple political majority may act in a predatory fashion. Such a super-majority provision, which could apply to referenda or parliamentary decisions on tax, has parallels in the Companies Act which requires a major transaction to be approved by at least a 75 percent majority of shareholders.

Tax and expenditure limits ignore base spending which, in New Zealand, adds up to 95 percent of the total. As the Organisation for Economic Cooperation and Development has noted, this spending is not properly reviewed. The key problem appears to be a lack of political will. Assessing value for money is not rocket science. It is simply a matter of demanding convincing answers to basic questions.

Ten years of experience show that the FRA has served New Zealanders well to date, except for the lack of real government spending discipline. Based on overseas examples, tax and expenditure limitation rules backed by citizen referenda and super-majority rules have the best chance of improving spending disciplines.*

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The record of progress

It is difficult, even for those who have lived through it, to fathom the pace of progress over the past half-century.

The OECD Development Centre recently published a study by economist and historian Angus Maddison presenting comprehensive estimates of population, gross domestic product (the total value of goods and services produced in an economy) and GDP per head for different countries and regions, and in the world as a whole, down the centuries. British economist David Henderson drew from this study for his book co-published by the New Zealand Business Roundtable last month, *The Role of Business in the Modern World*.

Historically, rising GDP per head has gone together with longer life expectancy, advances in health, higher educational standards, some notable environmental improvements, and greater leisure; and it can reasonably be taken as a first-approximation measure of material living standards.

Henderson uses Maddison's figures to make the point that in 1950, Australia and New Zealand already had a well-established claim to be viewed as economic success stories: they ranked as the third and fourth richest countries in the world, after the US and Switzerland. Australian GDP per head was $7,400 using 1990 US dollars as a measure. The annual rate of growth of GDP per head over the 80 years from 1870 to 1950 was close to 1 percent. A continuation of this growth rate would have resulted in GDP per head in Australia of $12,000 in 2000. A more optimistic projection, using 1.5 percent growth, would have produced a figure of $15,500. In the 1950s, such an outcome would have been seen as close to the upper limit of the possible.

Australia's average annual growth rate between 1950 and 2000 was 2.1 percent and GDP per head in 2000 was close to $21,500 – almost triple the 1950 figure. Judged by past standards, which had made Australia one of the richest nations in the world, this has been a truly remarkable improvement in performance.

Yet Australia's experience over this time was not unusual. In fact, the nation's relative position in the world had slipped by 2000 and New Zealand's had slipped even further. Almost without exception, nations which were already well advanced in 1950 had grown since then at average rates comparable to (or higher than) the rate of growth of Australia.

Up until 1950, some questioned whether it was possible for modern economic growth to be achieved outside a so-called 'magic circle' of countries which were all – with the exception of Japan – either European or of predominantly European origin. This view has since been completely dispelled. Leaving aside the smallest economies with a population in 2000 of less than 1 million, Maddison's evidence shows some 25–30 newly successful countries. Among these, 15 have seen an

increase in GDP per head greater than fivefold between 1950 and 2000: the list includes Greece, Portugal and Spain in Europe; and in Asia, Hong Kong, Malaysia, Singapore. South Korea, Taiwan, Thailand and – last but far from least – China.

For most of the world the period from 1950 to 2000, judged by all past standards, emerges as one of striking economic progress. Other indicators of welfare have also risen: life expectancy in less developed countries rose from 41 years in the 1950s to 66 years in 2000. And as David Henderson notes "In the course of the past half-century or so, the numerous citizens of the more economically successful poorer countries have been rapidly catching up with their counterparts in the former magic circle."

Not surprisingly, these success stories are only part of the picture. In many poor countries, especially though by no means only in Africa, progress has been slow. These countries have been falling further behind both the rich countries and the more dynamic developing economies. Much has been written about the 'widening gap.' But it is not the gap between richer and more dynamic economies and the less successful poorer ones that poses a problem, but the slow rate of progress in the latter. The economic progress made by countries in general, and poor countries in particular, is to be welcomed. It should not be labelled as a problem, or as a source of injustice, merely because not all countries have shared in this success.

The past half-century offers clear evidence of rapid, sustained and increasingly widespread improvements in material welfare. Looking at both the success stories and the failures of these decades, including of course the failure of the communist experiment, a general moral can be drawn. There is good reason to think that it is the framework of economic freedom and competitive market economies, in rich and poor countries alike, which has played a decisive part in making such achievements possible.*

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Is there a problem with New Zealand's management capability?

Is New Zealand management up to scratch? Are managers as good as their counterparts abroad? Could a lack of management capability be holding back business and the economy? What might be done to improve management performance?

These are legitimate and important questions. How can we get a fix on them? Casual, anecdotal observations can't amount to a general picture. Opinion surveys are necessarily subjective. Any rigorous investigation must proceed by examining relevant theory and evidence.

Those who believe New Zealand management is not up to scratch must explain how this could be so in a competitive environment. A plausible hypothesis is that competition will force firms to continuously upskill, innovate and adopt best practices, and weed out poorly performing firms and managers. Firms will make mistakes but they won't do so systematically or they won't survive. Underperforming firms will fail to attract capital and other resources. Outperformance is unlikely to be sustained for long periods either: competition is likely to force returns back to normal levels. This is how competitive markets work.

What does this analysis tell us about the likely quality of management in New Zealand today?

Clearly a large swathe of the economy is now open to competition. Firms producing internationally traded goods and services have to compete on world markets and withstand competition in domestic markets with little protection. Most markets are open to entry – there is nothing to stop new firms setting up and taking business from existing ones if they are doing a poor job. New competition can come from anywhere in the world – there are few restrictions on foreign investment. New Zealand management should no longer be thought of as comprising just New Zealand-born managers or New Zealand-owned firms. And even though our takeover laws have been made unnecessarily restrictive, underperforming companies can be taken over and management teams replaced.

Is empirical evidence consistent with the hypothesis that, in competitive parts of the economy, management performance measures up? Yes. The bottom line test is profitability. On average New Zealand firms create value on a par with overseas counterparts.

The quality of management will also be related to pay – highly competent managers will be worth more to shareholders than less competent ones, and competition for their services will typically mean they are remunerated accordingly. In a small economy there will be limits to the level of competence

that it is economic to hire, but companies have incentives to go for the 'right' mix of pay and competence for their circumstances.

Critics of New Zealand business management who linked it to a period of underperformance of the sharemarket have fallen strangely silent as our market has outperformed many others in recent years. Neither period demonstrated either inferior or superior management – the link is spurious.

Likewise, the link critics have made between management and the overall performance of the economy is specious. It would be absurd to suggest Japan's world-beating performance in the 1980s was due to the quality of its business management and that its stagnation in the 1990s was due to a sudden loss of skills. No recognised economic theory attributes differences in countries' economic performance to differences in innate management capabilities. Research has confirmed the earliest insights of economics that differences in the wealth of nations are primarily due to the policies and institutions (such as the rule of law and security of property rights) they adopt. Rod Oram's claim (*Boardroom*, February 2004) that "good companies thrive in spite of poor government policies" is simply nonsense as a general proposition: How many Microsofts did the Soviet Union produce? A good environment breeds good business people, not the other way round.

Economics teaches that people respond to incentives. The quality of New Zealand management has improved in response to the new competitive environment. To make further improvements we need to particularly focus on areas where competitive disciplines are weak, such as the state-owned enterprise, education and health sectors, and the public sector in general. We also need to eliminate obstacles to better management performance, such as employment legislation which makes it difficult and costly to remove non-performing managers.

Does this mean we can be complacent about the quality of New Zealand management? Of course not. Firms, business schools and organisations should constantly strive to upgrade it. But it does mean we should analyse issues of management capability competently and look for remedies in the right places.

By contrast, we should ignore the drivel about management failures from people who have never run a major business in their lives. If, as Rod Oram and others keep telling us, New Zealand managers are "failing" "short-termist," "inept," "do-nothing" and "oblivious to the imperative of strategic leadership," there must be opportunities for smart people like them to make fortunes.

Curiously, however, the 'rich lists' never seem to contain their names. I wonder why?*

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*First published in *The Otago Daily Times* on 27 August 2004.

Serving the public, not just the politicians

The controversy surrounding comments by Maori Language Commission chief executive Haami Piripi and the resignation of Maori Party activist Amokura Panoho from the Department of Labour have put public servants in the spotlight. This has revived deep-seated questions about the roles and responsibilities of people employed by the government of the day.

The New Zealand Business Roundtable has taken a keen interest in public sector performance. In 2001 it published *Public Management in New Zealand: Lessons and Challenges* by former secretary of the New Zealand Treasury Graham Scott.

Dr Scott traced the path toward the public sector reforms of the 1980s and 1990s. "Ministers and permanent secretaries, lined up in matching hierarchies, had long been engaged in a comfortable dialogue while waiting in turn to get the top jobs as their older colleagues retired. This was swept away." Many public institutions, with resources indexed to inflation, had not really challenged their internal thinking for years. Women were no longer prepared to tolerate the lazy sexism that accompanied life in the public service. Graduates from the 1960s rose up the ranks and agitated for change in management systems dominated by middle-aged men who usually had lesser qualifications. Recognition of the Treaty of Waitangi became more important, and new policy tasks demanded skills in analysis that many in senior positions did not have.

The reforms were one of the ways the public sector responded to this sea change. Major building blocks were the State Sector and Public Finance Acts, the restructuring of organisations, and the formalisation of expectations of public servants. The result, according to Dr Scott, was a generally robust public management system. "Even the harshest critics of the public management reforms acknowledge the benefits that have flowed from having a consistent framework to work from." Large-scale structural change is not on the agenda of the present government.

This is not to say that everything is right. Public servants should be servants of the public, and not just of the government. This is what is meant by the concept of an independent and apolitical public service. The job of policy ministries such as Treasury, the Ministry of Economic Development and the Ministry of Social Development is to give free and frank advice. (Of course, once the government has made its decisions, it is the job of public servants to implement them.)

Delivering unwelcome advice is crucial. Government ministers should not be surrounded by 'yes' men and women. Yet public servants do not appear to be delivering forthright views. An illuminating example: No departmental

chief executive offered advice to ministers on whether the government should ratify the Kyoto climate change accord. Ratification could have far-reaching and harmful implications for economic activity and for the living standards of New Zealanders. It could put the competitiveness of many major industries at risk. The government decided last year to ratify, without ever being offered candid analysis of the ramifications.

This is not unique. The biggest single new package in this year's budget was the "Working for Families" wealth redistribution package. There was no advice from the Treasury on the package put to cabinet, and its limited reporting during the development of the proposals lacked breadth, depth, rigour and, most importantly, firm advice. The group of public servants most qualified to analyse the expected policy outcomes didn't carry out their role. It appears that public servants with unwelcome advice have become marginalised.

Dr Scott warned in 2001: "It is a concern that [the] public service commitment is under pressure from ministers and, that some senior officials are giving in to it. The state services commissioner has stated firmly that he stands for free and frank advice, but he may have to intervene with ministers and some senior officials at times..." To date, there has been no major sign that key public servants or the government have moved to address the problem.

According to Dr Scott, the impulse for better policy and evaluation could be strengthened if ministers asked for and expected this advice from departments, and if the performance management system revealed weaknesses. At present, it seems many ministers do not want neutral, independent advice; instead they prefer to rely on politically appointed staff in their offices.

When the State Sector Act was passed, the idea was that public servants would be properly paid and held accountable for performance. There has been little sign of the latter. Few chief executives have been fired compared to the private sector. One wonders whether every top public sector manager can really be that good. The peak of policy capability in New Zealand can match international standards, but the peaks are too rare.

It is to be hoped that the recent controversies might spark a wider discussion about the relationship between public servants and incumbent governments. The vision of outcome-focused public management that was the inspiration for the 1980s and 1990s reforms needs to be reinvigorated.*

*First published in *The Otago Daily Times* on 13 August 2004.

The role of business in historical perspective and today

The last thousand years have been dubbed the 'millennium of the market.' While the population of the world rose twenty-two fold over the last thousand years, world gross domestic product (at purchasing power parity) rose thirteen times as fast. Much of the economic growth occurred in just the last two centuries. The astonishing increase in population, output and incomes per head has no earlier parallels.

Financial Times chief economics commentator Martin Wolf – who is giving the 2004 Sir Ronald Trotter lecture for the New Zealand Business Roundtable (NZBR) in September – says in his new book *Why Globalisation Works* that "the historically unprecedented economic dynamism of the last two centuries and the divergence in performance across countries are the two most important features of the world we inhabit."

The dynamism, he argues, results from institutions, practices and attitudes that first emerged in western Europe over an extended period. These cultural, social and political advantages combined with the proximity of coal and iron.

The divergence was the result of the uneven reach of rapid economic growth. Growth spread swiftly from Britain to the rest of western Europe and the former British colonies. Incomes converged strongly among these countries. Rapid growth also jumped from one end of Eurasia to the other once the United States forced Japan to open up its economy. Yet, as Martin Wolf states, "the overall picture of a world in which some countries have economies that grow more or less consistently while others do not is correct."

If we are to ensure nations that have not had strong economic growth catch up, we must understand what the source of it is. Fellow British economist David Henderson – author of the forthcoming NZBR publication *The Role of Business in the Modern World* – has looked closely at the background to sustained high growth rates.

Henderson concludes that sustained high growth has owed little or nothing to direct foreign assistance, whether bilateral or multilateral, to public-spirited conduct by large international firms, or to collective resolutions and initiatives on the part of the international community.

Rather, David Henderson concludes, "everywhere the material progress of people, rich and poor alike, depends primarily on the dynamism of the economies in which they live and work." The progress of workers does not chiefly depend on the activities of trade unions or the regulation of wages and employment. Such moves can make economies less dynamic. Advances made by lower income

earners through the development of social services and income redistribution can be overshadowed by the gains which arise from economic growth.

Henderson believes the background conditions required for dynamic growth are: a stable government acting responsibly in matters of public finance and the control of the money supply, property rights that are well established and maintained, a system which leaves most economic decision-making in the hands of private individuals and enterprises, and an economy that is substantially open to transactions with the rest of the world.

His finding is consistent with the *Economic Freedom of the World* annual survey, of which the NZBR is a co-publisher. Recently released, the 2004 edition shows that the reforms of the 1980s and early 1990s continue to pay dividends for New Zealand, while latter day tinkering has slowed progress.

A large question remains: what is the *source* of economic progress, as distinct from the *conditions*? David Henderson answers: "the primary direct impulse to economic progress comes from profit-related activities and initiatives on the part of business enterprises." As Henderson notes, this is true of countries everywhere, past and present, and rich and poor alike.

Henderson quotes economist Joseph Schumpeter, who wrote in 1942 that "the fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organisation that capitalist enterprise creates." It is apparent that economic growth increases not just material wealth, but also opportunities for innovation. Technical and scientific progress can therefore be seen as part of a business-led process of change. In other words, invention and innovation are largely economic activities performed by companies to meet the demands of consumers.

Competitive pressure is another factor in the impressive performance of market economies. Businesses make investments, introduce changes and engage in innovation to exploit perceived opportunities and ward off threats to the bottom line.

Past history, especially of the past half-century or so, offers clear evidence of rapid, sustained and increasingly widespread improvements in material welfare. David Henderson believes:

There is good reason to think that profit-oriented 'capitalist' business enterprises, operating within the framework of competitive market economies, have played, and are continuing to play, a large part in making such achievements possible. From an economy-wide perspective, as distinct from that of the individual firm, this is the primary role of business.

Thus defined, the primary role of business is not one that individual enterprises consciously set out to play. Within it, businesses are cast as agents of market-led change, but not because they have chosen to act as such.

From an economy-wide standpoint, business is instrumental to material progress – and its role has changed little over a millennium.*

*First published in *The Otago Daily Times* on 30 July 2004.

Understanding New Zealand's terms of trade

The notion that New Zealand's terms of trade have been in continuous long-term decline is familiar, of long standing – and wrong.

The terms of trade are the relationship between the prices of exports and the prices of imports. An overseas terms of trade index is calculated as the ratio of the total export price index to the total import price index.

An increase (decrease) in the terms of trade index indicates that the real purchasing power of exports has increased (decreased).

The terms of trade are not directly affected by exchange rate changes, which have equal and offsetting effects on export and import price indexes.

The idea that the terms of trade were moving against New Zealand was popularised by finance minister Robert Muldoon at the time of the 1970s oil shocks. He used to explain that with the hike in oil prices, more bales of wool were needed to purchase a barrel of oil. He was right at the time.

But the idea that New Zealand faced an unfavourable trend in its terms of trade goes back further.

It was widely believed – and not only in New Zealand – that agricultural exporters (particularly of commodities) were destined to see their terms of trade fall relative to those of industrial economies. Hence the push for import-substitution policies in many countries, including New Zealand, to protect and foster secondary industries.

But as the chart shows, the big story is in the swings in the terms of trade, not the trend.

Our recent merchandise terms of trade are at about the same level as they were in the 1890s; the trend has been upwards in the past 20 years; and there is no law of economics that says they will decline in the future.

Indeed, with China and India likely to be hungry for food, fibre and other New Zealand products in the decades ahead, the trend could well be favourable – even for commodities.

Moreover, a deterioration in the terms of trade does not necessarily imply a reduced standard of living. The decline in price can be offset by increased productivity.

As a major oil importer, Japan's terms of trade fell far more than New Zealand's in the 1970s, but its economy performed strongly due to the exceptional productivity growth rates of its export-oriented manufacturing sector.

The prices of 'new economy' products like Microsoft's software and Intel's computer chips have fallen precipitously in the past 20 years, but productivity gains have outstripped the price declines and kept these firms profitable.

A narrow focus on the terms of trade leads to incorrect conclusions. People are apt to write agriculture off, or to advocate more elaborate processing of basic commodities.

Moves to further processing, branding and differentiated products may or may not make sense. The key issue is profitability, not arbitrary distinctions between primary and other industries, or between commodity and non-commodity products.

Such production decisions are for entrepreneurs and investors to make. Government policies should be neutral between them.

Future trends in the terms of trade are unknowable; there is no reason to assume they will be adverse on a long-term basis; and they are irrelevant to contemporary public policy.*

*First published in *The Dominion Post* on 19 July 2004.

It's yesterday's schools once more

One of the key principles underlying the *Tomorrow's Schools* reforms was the notion of community involvement in education. The Labour government's original concept was a partnership between professionals and communities, with the board of trustees the linking mechanism. Anyone familiar with the subsequent history of the New Zealand school sector knows that things have not quite worked out that way and the original vision has never been realised.

The reforms introduced in 1989 – including parent-dominated school boards of trustees – have been largely successful and remain a distinguishing feature of the New Zealand school sector. Subsequent reforms such as the bulk-funding of teacher salaries and the abolition of school zoning in the early 1990s built on the initial moves. Unfortunately, the period since the late 1990s has seen a steady erosion of community and parental control over education and a recentralisation of decision-making in Wellington.

The 1998 changes to school enrolment scheme legislation under National were only the beginning. The pace of recentralisation has accelerated since late 1999, with a further 'tightening' of enrolment legislation, the abolition of bulk-funding of teacher salaries and the re-introduction of a collective contract for school principals. The result is a school system that is hugely influenced by education 'central command.' Just last week, news reports highlighted the extent to which the Ministry of Education continues to control schools. Forty-six schools were believed to have broken the law because they had not sought ministry approval for their pay offers to principals. The centrally driven schools closure policy and the minister of education's decision to sack the parent board of the Correspondence School are further evidence of the degree of central control in the system today.

More threats loom. The proposal to give the secretary of education the power to dock the pay of striking teachers and the potential for increased regulation of integrated schools would both be further nails in the coffin of *Tomorrow's Schools.* Ministry of Education documents suggest its role is likely to expand, rather than contract. In a recent strategic document (called a statement of intent), it boasts that it "has been extending its range of activities" and that it is "no longer the hands-off Ministry that followed 'Tomorrow's Schools'."

Unfortunately, the ministry document does not provide any evidence that its interventions do much good or that the 'Wellington knows best' school system will mean better education outcomes than one where communities and parents play a much greater role.

A report released in late May by the Maxim Institute, *A Snapshot of What Parents Think of Schooling in New Zealand*, suggests that the increasing intrusiveness in schooling is not something parents support. Indeed, the view from

the parents interviewed was that the government should be less intrusive, more trusting with teachers, principals and especially parents, and more democratic.

The report canvassed the views of the parents of 137 children from right across the social spectrum. It consistently records that parents care passionately about schooling for their children. They go to great lengths to find out about schools through a variety of means, including word of mouth, Education Review Office reports, NCEA results and league tables. The report includes a number of other interesting findings:

- school zoning policy constitutes a major frustration for parents who want more direct control of schooling for their children;
- school discipline was a major decision factor for parents when choosing schools;
- teacher quality is of great importance to parents;
- parents were critical of the government and Ministry of Education roles in the education system and the fact that the autonomy which *Tomorrow's Schools* promised was unrealised;
- parents wanted a significant 'say' in their children's education; and
- parents believed that the best schooling situation was one where school life and values mirrored, or supported, parental values.

While the results are suggestive only, given the nature of the survey, they are instructive. They indicate that top-down, one-size-fits-all solutions simply won't work in a school system where the needs of children and the desires of families are so individualised. They also indicate that we should have confidence in the ability of parents to make the right decisions for their children. It only makes sense – parents have a far greater interest in the welfare of their children than bureaucrats in Wellington.

The clear message from the Maxim report is that we should show a little faith in the ability of parents to 'do the right thing' for their children. Given the chance and, where required, a bit of help, they won't disappoint. As Thomas Jefferson said, "I know of no safe depository of the ultimate power of society but the people themselves and if we think them not enlightened enough to exercise their control with a wholesome discretion, the remedy is not to take it from them, but to inform their discretion."*

*First published in *The Otago Daily Times* on 16 July 2004.

Hard-headed spending decisions not cold-hearted

The big challenges that confront humanity are well-established. Conflict, communicable diseases, hunger and malnutrition pose an ongoing threat. Developed countries attempt to respond through the United Nations apparatus and aid spending. Each challenge comes with a range of solutions or ways to ameliorate the problem; each solution has its own price tag.

The question the developed world has never really addressed is this: With limited resources, which solutions to which challenges should be at the top of the list of priorities?

Too often, important funding decisions are swayed by rapidly changing media images of the latest catastrophe or tragedy. Prioritisation occurs implicitly because no dollar can be spent twice.

If an overcrowded emergency ward gave up the practice of triage, the human cost would quickly mount. The same occurs when we fail to use a rational basis to decide how to spend money to improve living conditions for the world's most disadvantaged.

Prioritisation is certainly a complicated task. Some claim it is impossible to judge between such things as a malaria vaccine and anti-corruption policies. Yet politicians set such priorities every day when they choose between increasing the health budget and improving crime prevention.

Some think that we should do everything. We should win the war against hunger and malnutrition, end conflicts and stamp out corruption, and also halt climate change. But we do not live in a world with the resources and political will to achieve everything.

Prioritisation is necessary – and it can be done. Last month the Copenhagen Consensus project brought together eight world-class economists – including three Nobel Laureates – to rank solutions to 10 great problems facing humanity. Their task, set by the Danish Environmental Assessment Institute and *The Economist* magazine, was to answer the question: If the world had US $50 billion extra to spend achieving good in the world, where could that money best be spent?

The architect of Copenhagen Consensus was 'Skeptical Environmentalist' Bjorn Lomborg, who came to New Zealand as a guest of the Business Roundtable in 2003. The Business Roundtable's communications advisor took leave of absence to work in Denmark as media liaison officer for the project. Lomborg's group spent a week hearing evidence on the challenges from 30 specialist scholars. They looked primarily at the numbers, establishing hard-headed economic priorities. If 50 million lives could be saved in one area for $5 billion, then logic would dictate that it should be done before spending $10 billion to do comparatively little elsewhere.

At the end of the week, the economists announced their results. At the top of their list was an HIV/AIDS prevention package. This would cost US $27 billion, but would have benefits almost forty times as high. As expert panellist Bruno Frey put it, "fighting disease is a good investment." Money spent controlling and treating HIV/AIDS would yield extraordinarily high benefits. Furthermore, the scale and urgency of the problem are extreme, especially in Africa where entire societies are threatened with collapse.

Other opportunities rated by the economists as "very good" were providing micronutrients to areas suffering from malnutrition, liberalising trade, and ameliorating malaria in disease-prone regions.

"Free trade will benefit both rich and poor countries," expert panellist Nobel Laureate Robert Fogel said. "Eliminating trade barriers does not require a big investment to produce a large return. Here, we need political will – and the return will be huge. The entire world's economy will benefit from free trade, and more wealth will mean that we can afford to solve more of the world's greatest challenges."

If Copenhagen Consensus showed developed nations what they should be doing, it also highlighted approaches that should not be immediate priorities for extra spending. The experts rated responses to climate change extremely low on the 'to do' list. In fact, they called these ventures – including the Kyoto Protocol – "bad projects." Expert panellist Vernon Smith said, "the environment is very important, but it's too early to be concerned with climate change. Action now is not essential as it is with AIDS, malaria and hunger."

Copenhagen Consensus also helped establish areas which require more research. The expert panel considered it impossible to prioritise responses to the challenges of conflict, financial instability and a lack of education because hard data on which solutions work is not available. Filling that information gap should be high on the short-term research agenda.

Throughout the week of Copenhagen Consensus activities, critics continued to denounce the economists' "tunnel vision." The criticism is flawed. A focus on costs and effects does not result simply in a cold-hearted view framed by dollar signs. Instead, it helps focus minds on the fact that resources are limited, and that explicit prioritisation is necessary in order to do the most good possible.*

*First published in *The Otago Daily Times* on 2 July 2004.

Cullen confuses company tax debate

In the budget, finance minister Michael Cullen spent nearly a page arguing against lowering the company tax rate.

Why bother? After all, both the McLeod Tax Review and the Treasury have said the top priority for boosting economic growth is to cut high personal rates and adopt a more uniform tax scale (with the top personal rate aligned to the company rate).

Dr Cullen probably understands this. The focus on company tax may be something of a diversion.

Dr Cullen is right to say that some business lobbyists seem unaware that for most businesses the company tax is barely relevant. All tax policy should be looked at from the viewpoint of the ultimate taxpaying individual. With imputation the company tax is largely a withholding tax and the investor's personal tax rate is what matters. The vast majority of New Zealand investors in widely held companies are on the 33 or 39% rate.

Moreover, around half New Zealand companies don't pay any company tax. In 2001 the IRD estimated that if the company tax rate of 33% were cut to Australia's 30% level, only 2% of companies would benefit by more than $10,000.

Foreign equity investors would benefit from a lower company tax rate. But Dr Cullen was wrong to tell the Herald recently that they would be "the only real gainers." New Zealanders at large would benefit because a smaller tax wedge would reduce the cost of capital and increase investment. Ireland's economic growth owes much to low taxes on foreign investment.

However, it is less expensive in revenue terms to reduce the tax burden on foreigners by increasing the foreign investor tax credit (FITC) than by cutting the company rate.

But Dr Cullen has shown no interest in taking either this step or reducing domestic investors' personal tax rates. The economic cost of taxes on capital income may be as high as 50% in New Zealand. In other words, for every additional dollar spent on, say, family support, 50 cents is lost in the transfer.

Dr Cullen's view that high taxes don't matter is consistent with his longstanding admiration of high tax welfare states like Germany: he has often commended the 'Rhenish model' for New Zealand. But Germany is the 'sick man' of Europe; it has averaged only 1.3% annual growth in the last decade and is now only two rungs above New Zealand on the OECD income ladder. And even Germany is cutting its company tax rate to 25% this year.

Following the McLeod report recommendations does not mean adopting inefficient payroll and capital gains taxes, or cutting expenditure as Dr Cullen

argued in the budget. Ireland's lower taxes have meant higher growth and more resources available for the public sector.

The Business Roundtable advocated a maximum personal and company tax rate of 25% to the McLeod review, and a 15% rate (via an increased FITC) on foreign investors. This would still put us above tax rates in Singapore and Hong Kong but New Zealand would at least stand out from the OECD crowd, and the benefits would be huge.*

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*First published in *The Dominion Post* on 7 June 2004.

Rate bias against business should go

On June 21, the Dunedin City Council will be releasing its annual plan for 2004/05, along with its decisions on rates.

The Otago Chamber of Commerce and Industry has rightly been urging the Council to lower the general rate differential applied to businesses.

The council proposes to levy non-residential ratepayers almost 0.97 cents for every dollar of rateable property, compared with about 43 cents for residential ratepayers.

On a national basis, the business sector pays around half the rates levied by councils. This is highly discriminatory. Businesses are largely disenfranchised in council elections because residential ratepayers have voting power. People like to get a free lunch if they can – to get the benefits of a service but have others pay for it. Local politicians are responsive to their pressures for spending and pass the bill to businesses.

The situation is similar to the distortions in power and telephone charges when these industries were run on political rather than commercial lines. Cross-subsidies from business to household consumers misallocated resources and made the community poorer.

It should be the duty of elected representatives to protect minority interests. Councils might argue that polls show a majority favours disproportionate rating of businesses. Polls might also show that a majority favours scrapping the Treaty of Waitangi. That does not make either a good policy. Arguably councils should be prevented from engaging in predatory rating policies by law – before 1969, councils did not have the power to set differential rates. To their credit, around half of our councils do not have a business differential. Others are reducing them, but too slowly.

Three main arguments are put forward for a business differential. They do not withstand scrutiny.

First, businesses are said to benefit from the ability to claim an income tax deduction for rates and a credit for GST paid on rates.

This is not concessional treatment. Businesses can claim a tax deduction for rates because the related gross income is taxable. Homeowners are not taxed on their imputed rental income (the economic income they derive from living in their own home) and therefore are not permitted to claim a tax deduction for their expenses. Taxability and deductibility go together.

No one seriously argues that it is an advantage to be subject to income tax. That is why many homeowners objected to the initial suggestion of the 2001 Tax Review that owner-occupied houses be brought within the income tax system.

In the case of GST, most businesses are required to pay GST on their outputs. They deduct GST paid on their inputs and they pay the net amount to the government. No tax advantage arises

The argument that tax treatment favours business ratepayers has been declared to be without substance by Audit New Zealand.

A second argument is that businesses have greater ability to pay and should therefore shoulder a disproportionate level of rates

This argument is predicated on the assumption that councils should be actively involved in income redistribution. However, this is the responsibility of central government. Moreover, the claim is based on mere assertion. Councils have no information on the relative wealth or income of business and residential ratepayers. It is necessary to look through business structures and examine the position of the investors or owners behind them. Typically they are not disproportionately well off. Many earn an income that is no higher than that of comparable salary and wage earners.

Thirdly, it is sometimes argued that businesses benefit disproportionately from council services, and should therefore pay a higher rate.

This argument reflects a misunderstanding of the proper role of councils. Councils should be in the business of ensuring the provision of public goods and services – like open-access parks, stormwater and flood control which the private sector cannot provide profitably. Private goods and services can be charged for, and businesses and other users should meet their true costs on a user-pays basis. However, it is not feasible to charge for public goods and services and they must be funded from taxes or rates. The general rate largely funds public good services that are intended to benefit all citizens. Such services do not disproportionately benefit the business sector. Indeed in some cases, eg farmers or rural firms that receive few council services, there may be a case for a lower rate differential.

In summary, business rate differentials owe everything to politics and nothing to good economics. They discourage business growth and job creation. Councils should move to eliminate them more rapidly, and curb their spending so that residential ratepayers do not have to take up the slack. In the case of Dunedin, the Chamber's advice should be heeded. If local government does not move to end unjustifiable rate differentials, central government should.*

*First published in *The Otago Daily Times* on 4 June 2004.

Budget shows why stronger fiscal controls are needed

In a recent paper for a World Bank conference, the 2002 Nobel laureate in economics, Vernon Smith, recounted a story of a taxi ride in 1978 from Wellington airport to his hotel. The driver was friendly, so he said, "Tell me about your country." The reply was, "It's really wonderful. I don't like paying half my small income in taxes, but we receive so much that is free: health benefits, prescriptions, free education through college and advanced graduate study. I am just a cab driver, but my son is going to be a medical doctor. He has finished his medical degree, and internship, and will begin practising next year." In recognition of the taxi driver's obvious pride, Smith said, "How wonderful. You have every right to be proud. Is he going to practise in Wellington?" The answer was, "Oh no, he's going to Australia. You can't make any money here."

Despite all the changes in New Zealand in the past 20 years, this problem has not gone away. Whereas in the 1950s one income earner was able to support a family, today even middle income families with two earners struggle to make ends meet. Why?

The main explanation is the rise of government spending, and the level of taxation needed to finance it, as a proportion of the economy. In addition, until the last decade, our growth rate has been poor.

In the mid-1950s, central government current spending was not much more than 20 percent of the economy. By 1978 it was half as large again, at over 30 percent. It is still around 30 percent today. On a broader basis used by the OECD to make international comparisons (which also includes local government and capital spending), government outlays today total around 40 percent of GDP.

The calculation of Tax Freedom Day is one way of representing this change. This is the day on which the average New Zealander stops working for the government and starts working for themselves. On the OECD measure, Tax Freedom Day this year was 26 May, the day before Dr Cullen's Budget. In the 1950s it fell in March and a generation earlier in February.

Another way of looking at it is that taxpayers earning over $38,000 lose 41 cents of the last dollar they earn and those over $60,000 lose 47 cents when they spend it and pay GST – or more when excise and other taxes are taken into account.

Dr Cullen had an exceptional opportunity to lighten tax burdens across the board in the Budget, but he blew it. Instead, the government has decided it can spend taxpayers' money better than taxpayers themselves, and is planning to spend an additional $14 billion over the next three years, or over $10,000 for every household. This is the mother of all spending extravaganzas.

The scale of the missed opportunity is apparent from a recent Treasury estimate that it would cost just $4.7 billion annually to lower all tax rates – personal and company – to a flat rate of 18 percent. As the Treasury noted, a tax reform of this sort would do most to boost economic growth. The same general approach was recommended by the McLeod Tax Review in 2001. It noted that a more progressive scale made the tax system more complex and distorting, and made only a small contribution to redistribution.

No one begrudges tax reductions for low income earners or help for struggling families. But beyond the short run, a focus on wealth redistribution (dividing the pie) rather than wealth creation (making a bigger pie) is a poor strategy for helping people to get ahead. Americans on low incomes understand this: polls show they oppose increases in higher tax rates because one day they hope to be richer too.

The tendency of political parties is to direct spending to their own voting constituencies rather than to the general public interest. Our Fiscal Responsibility Act of 1993 has increased fiscal discipline but it has failed to curb excessive spending and taxation.

With the benefit of 10 years' experience, there is a strong case for introducing limits on spending and taxation along the lines followed in a number of countries and American states. Taxpayers should be given more control over spending. Excess tax receipts belong to taxpayers and should be returned to them unless they decide otherwise (through a referendum).

New Zealand is never going to achieve the growth rates needed to get back into the top half of the OECD income rankings, and make itself an attractive place for mobile people (like the son of Vernon Smith's taxi driver) to work, with government spending around current levels and tax rates to boot. The time has come for a serious debate on more effective ways of restraining Leviathan.*

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*First published in *The Press* on 28 May 2004.

Sizing up the 2004 Budget

In just under a fortnight, finance minister Michael Cullen will be bringing down the 2004 budget. How should we think about it?

The government has said that it "sees its most important task as building the conditions for increasing New Zealand's long term sustainable rate of economic growth." It surely follows that the main thing the government would expect commentators to focus on in the budget is whether it is achieving its top priority goal.

The Labour-led government that came into office in 1999 inherited a much stronger, more productive and resilient economy. Largely as a result of the reforms of the 1980s and early 1990s, the economy grew by 4 percent a year in the five years to 1996 and has averaged 3.5 percent annual growth in the last decade. However, contrary to the government's aim, there has been no improvement in the rate of progress. As the OECD put it in its recent report on New Zealand:

> The slide in relative living standards vis-à-vis the OECD average seems to have been arrested, but a further acceleration – necessary if New Zealand is to move back into the top half of the OECD ranking, as the government is intent on doing – is still not in sight.

Two years ago, Dr Cullen said that by the middle of 2004 it would be apparent whether the government's growth strategy was on track. This month's budget will almost certainly confirm that no acceleration of growth is in sight. In the terms of the NCEA, I think Dr Cullen's scorecard will be 'not achieved.' If I am right, this should be the most important headline of budget commentary.

The budget is not the place for many growth policies to be addressed. However, it is the place where the government brings together its plans for spending and taxation, both of which have a big impact on growth.

The first point to make is that big government harms growth. It is not credible to suggest that New Zealand can achieve sustained per capita economic growth of 4 percent or more a year – the kind of rate the government is targeting – with government spending (central plus local) at its current level of around 40 percent of GDP.

However, there is no sign that the government intends to reduce this high and excessive spending ratio. To the contrary, it intends in the budget to use buoyant tax revenues to go in for what Westpac bank economists have called a "spending extravaganza." They point out that the fiscal forecasts show a cumulative $13.3 billion increase in spending over the next three years, almost double the allocation for the same period in the 2003 budget. If the extra spending wasn't considered to be value for money 12 months ago, how come it suddenly is now?

What about the tax and revenue side of the budget? Here again the direction of policy is clear if the government were serious about growth. High personal tax rates and high taxes on capital income are among the most damaging to the economy.

From a growth perspective, the 2001 McLeod Tax Review found that the government's move to increase the top personal tax rate to 39 percent was a mistake. It recommended that New Zealand should adopt a lower, flatter tax structure, and that the top personal rate should be lowered and aligned with the company rate.

The Treasury has recently released a paper on growth which makes similar points. It says that the greatest impact on economic growth would come from moving to a flat rate for both personal and corporate taxes. It calculates that the annual fiscal cost of moving to an 18 percent tax rate would be approximately $4.7 billion. In the context of planned government spending increases of $13.3 billion over the next three years, it is clear that an 18 percent rate would be easily affordable.

The government has slowly been killing the goose that has been laying the golden eggs. Economies grow when governments get out of the way. Our government's role in the economy is becoming ever more intrusive. Just as it took time for the benefits of better policies to show up, so it takes time for bad policies to take their toll. The budget projections are likely to confirm that they are doing just that.

In that event we must hope that the government will reconsider its growth policies, as it has reconsidered policies in other areas, or that other political parties will offer voters more credible policies at the next election. The success of the earlier reforms greatly improved the country's outlook, but there is no excuse for not doing a lot better yet. A wide and growing income gap with Australia and other better-performing countries is not – I suspect – what most New Zealanders want to look forward to.*

*First published in *The Otago Daily Times* on 21 May 2004.

Education really does matter

The government's back-down on school closures, the review of the integrated schools act and the threat of closure hanging over hundreds of early childhood centres have once again put education at the centre of public debate. For parents and families who are potentially affected by government policy changes, abstract concepts such as 'school choice' and 'school governance' have been given real meaning.

While there is often much reporting of things education in New Zealand, good debate over the underlying issues is less common than it should be. And much of the policy discussion is poorly informed – especially when it is relies on the superficial analysis of educrats and many in the education academic community. Why debate serious issues like curriculum, qualifications or parental choice of school when it is so much simpler to blame any failings in the system on colonisation, the 'New Right' and fatty foods (or whatever happens to be the target of the protest of the week)?

The potential for good debate over schooling issues just went up a notch as a result of the publication of a recent Education Forum book called *Education Matters: Government, Markets and New Zealand Schools*. The book, by education economist Mark Harrison, formerly of the Australian National University, provides a comprehensive examination of many of the issues that are central to today's education debates. These include teacher quality and teacher pay, the role of choice and competition in schooling, school governance, curriculum and assessment and the impact of government spending on education outcomes. It looks at both the theory and empirical evidence underlying these issues.

There is a general consensus that New Zealand educational standards are reasonable but not outstanding in international terms. And there is also agreement that we have a long tail of under-achievers.

According to Harrison, the weaknesses with the existing school system largely stem from the fact that it is a centralised and politicised monopoly. The way to address this problem is to move away from government provision toward a decentralised market that allows families to choose between different types of schools run by competing providers. Or as Harrison succinctly describes it, the solution is to "decentralise, privatise and introduce competition." Under Harrison's reform model, government funding would follow the student and all schools would be funded in a neutral manner – whether they be public, private, integrated or for-profit. Students, not the ownership of school buildings, would be the focus of education policy.

The book provides a timely demolition of many of the myths peddled by those who oppose choice, competition and the private sector in education. At the top of this list is the view – popular among parts of the education academic community – that competition and choice harm the poor. As Harrison shows, the opposite is true – increased choice and competition would benefit the poor because they have fewer educational options under a centralised, one-size-fits-all system where school attendance is linked to where you live. To support his contention, Harrison points out that Maori and Pacific families took the greatest advantage of school choice when it was introduced in the early 1990s.

Good teachers would also gain from a less centrally controlled system because it would create competition for teaching services and reward good teaching. If teachers were treated more like other professionals, the only losers would be teacher unions.

Mark Harrison's book is the latest salvo in the education reform debate in New Zealand. There have been other contributions in recent months. The Education Forum's own *A New Deal: Making Education Work for All New Zealanders*, released last October, outlined a similar vision for the school sector.

Recent policy trends in New Zealand education have been in the opposite direction. The government's 'Wellington knows best' education policies have limited parental choice and progressively removed much of the autonomy that schools were given as part of the Tomorrow's Schools and subsequent reforms.

Other countries are taking bold steps in providing increased choice and diversity within a publicly funded school system. In the United States, there are some 2,700 Charter schools, which often have an area of specialisation and also face tighter accountability standards in exchange for greater managerial freedom. Specialist schools, which have an area of excellence such as science, sport or the arts, now represent more than half of all secondary schools in England. The book's proposals for market-based reform would bring New Zealand closer to countries such as Ireland, Denmark, the Netherlands, Canada, Australia and Sweden, where greater parental choice and a greater role for the private sector have been features for years.

Let's hope the government and other political parties are listening.

Mark Harrison's book *Education Matters: Government, Markets and New Zealand Schools* is available for $39.95 from the Education Forum (www.educationforum.org.nz).*

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*First published in *The Otago Daily Times* on 7 May 2004.

Flirting with Florida's follies

Snake oil seems to be a renewable resource. Only the brand changes.

The latest brand to hit town is the ideas of Richard Florida, a Carnegie Mellon professor whose book *The Rise of the Creative Class* argues that cities must become trendy, happening places to compete in the twenty-first century.

Florida spoke at last year's Knowledge Wave conference and a study group from the Wellington City Council visited the United States shortly after to look at the guru's approach.

Florida's ideas appeal to advocates of busy government. Cities, he argues, should dispense with stuffy old theories of economic development – like the notion that low taxes, business-friendly regulation and good infrastructure attract investment and jobs – and instead should spend heavily on things like cultural events and amenities, bike paths and ice-skating rinks.

Such places, Florida says, attract gays, bohemians, ethnic minorities and the 'creative class' in general, and become economic powerhouses.

The Council says it has not bought into all of Florida's nostrums, but they have "influenced its direction."

There is only one problem with Florida's ideas: they don't work. This should be obvious. How likely is it that they would have escaped the best minds that have studied economic development from Adam Smith to the present day?

And they have been mugged by facts. Critics have pointed out that US cities that rank high in Florida's indexes of creativity have been chronic underperformers. They score badly for job growth and entrepreneurship, and there is little evidence that people or businesses set much store on Florida's prescriptions. Only the internet bubble gave brief credence to them.

Instead of continuing to have flights of fancy – from Sesquis to Florida's follies – our councillors should be addressing the obstacles to development that are staring them in the face, as the business community has been saying for years.

This was the conclusion of Paul Romer, a much more distinguished US economist than Florida, who also spoke to the Knowledge Wave conference. His first words to me were: "Why don't you fix your roads?"

Recent projections by the New Zealand Institute of Economic Research suggest that the growth rate of the Wellington region over the next 20 years, at 2 percent a year, is likely to lag far behind Auckland's growth rate of 3%. This is despite Auckland's neglect of its roading infrastructure, which Wellington shows every sign of matching. The inner-city bypass was first mooted nearly 40 years ago: how much longer will it take before the Council pours a lot more of its energies into its core business and the next major project?

We need councils to perform their proper role of seeing to the provision of public goods like infrastructure; it is not a matter of 'leaving everything to the market.' But they should not play at being economic theoreticians peddling snake oil: snakes don't produce oil.

This week the Local Government Forum, a grouping of national business organisations, is releasing a much more down to earth analysis and ranking of councils around the country in terms of whether their policies are business and growth-friendly or not. This will have messages for Wellington. Watch this space.*

*First published in *The Dominion Post* on 26 April 2004.

Good policies depend on getting our priorities right

Next month a group of eminent economists, including four Nobel laureates, will meet in Denmark as part of the Copenhagen Consensus conference.

It is being organised by Denmark's Environmental Assessment Institute and co-sponsored by *The Economist* magazine. The director of the Institute, Bjorn Lomborg, is the author of the best-selling book *The Skeptical Environmentalist* which challenged the litany of over-hyped environmental disaster scenarios. Professor Lomborg gave the Business Roundtable's 2003 Sir Ronald Trotter Lecture on the topic 'The Real State of the World' (available at www.nzbr.org.nz).

The Copenhagen conference will examine 10 of the biggest challenges facing the world in the twenty-first century, ranging from climate change and communicable disease to conflicts, malnutrition and trade barriers.

The task of the participants is to assess the costs and benefits of ways to solve or ameliorate these problems, and compare these opportunities with each other. Thus they will produce estimates of the costs and benefits of providing clean drinking water to people who lack it, and compare them with the costs and benefits of investing in a malaria vaccine, or of combating global warming through the Kyoto Protocol.

The goal will be to establish priorities for using the world's resources to deal with these problems. In an ideal world, all such problems would be addressed, but economic resources are scarce and we have to prioritise. It makes sense to use resources where the returns – in terms of overall economic or environmental improvements – are the largest.

Lomborg illustrated these real-world trade-offs in his Trotter Lecture using the example of the Kyoto Protocol.

There is general agreement that even if Kyoto were implemented in full, it would only have a minimal effect on global temperature increases – perhaps of the order of 0.2 degrees celsius by 2100. Thus the benefit would be to postpone warming that would otherwise happen by about 6 years – not a large gain.

On the other hand, the costs could be astronomical. Limiting the temperature increase to 1.5 degrees celsius could cost around US$38 trillion. Lomborg argues this is simply a bad deal. For the cost of just one year's implementation of Kyoto we could give clean drinking water and sanitation to everyone on the planet, saving two million lives each year, and then go on to deal with other high-priority, high-return problems.

Applied to New Zealand, the calculations are similar. The New Zealand Institute of Economic Affairs has estimated that adopting Kyoto would reduce New Zealand's long-term annual growth rate by about 1 percent – lowering it

from 2.5 percent to about 1.5 percent. On this basis, the loss to the economy over just 10 years would be around $15 billion.

That amount of money could go a long way to solving New Zealand's far more serious environmental problems – such as traffic congestion and pollution in Auckland, winter smog in Christchurch, poor water quality in many parts of the country, and loss of native species due to possums and other pests.

The enthusiasm of New Zealand governments to 'lead the world' on Kyoto has never made sense. Moderate warming, which in New Zealand's case would mean temperature increases of perhaps 1–2 degrees celsius, would arguably be beneficial – in terms of lifestyle, health and agricultural production. Given other priorities, the use of resources to minimally curb warming would certainly be a gross waste.

Fortunately, Kyoto is not going to happen, even if Russia does ratify. Many major signatories are nowhere near on track to meeting their commitments; electorates will not accept the poor deal that Kyoto represents. It will be replaced by more cost-effective strategies to offset warming.

For example, Lomborg points out that the United States right now is spending around $200 million annually on research and development related to renewable energy. If this were increased tenfold, it would still represent only 1 percent of the estimated cost to the United States of implementing Kyoto. Yet it would probably do much more good, in the sense that it would bring forward, by at least a few years, the switch to renewables.

In his Trotter Lecture, Lomborg gives another example of priority-setting. He reports research showing that in the health sector the median cost of saving one human life in the United States was about US$19,000, in housing US$36,000, in transportation US$56,000 and in the workplace US$350,000. In the environmental area, when saving lives was the primary motive, the cost was US4.2 million. "Spot the bad investment," Lomborg says. If the US$4.2 million applied to particular environmental policies had been redirected to health, 200 lives could have been saved instead of one.

If the Copenhagen Consensus succeeds in throwing more light on the challenges of the next century, it may help countries prioritise environmental and other issues in more sensible ways, and avoid 'cures' which are worse than the disease.*

*First published in *The Otago Daily Times* on 23 April 2004.

Government failure, not market failure, is today's big problem

After the improvements in the Thatcher years, Britain's national productivity growth rate is falling. By 2008/09, the world's fourth-largest economy is projected to have its highest tax burden for 20 years. The cause, according to ex-Vodafone chief executive Sir Christopher Gent, is the bloated and inefficient public sector.

Speaking as chairman of lobby group Reform (www.reformbritain.com), Gent recently gave an address at 11 Downing Street where he listed some "uncomfortable facts":

- Britain has a higher crime rate than almost every other developed country. Despite extra resources devoted to policing, crime is no longer falling.
- National test results show a quarter of children passing through schools without learning to read and write to minimum standards – while the standards themselves are being eroded.
- Britain's cancer cure rate lags far behind those of other developed nations. Just under one million people are on public health service waiting lists. While the longest waiting times have reduced, average waiting times have risen by nearly 15 percent.
- Britons enjoy the longest journey to work and the most congested roads in Europe.

"This lamentable record," according to Gent, "is not market failure, because no market exists in these services. It is state failure."

Given our British traditions and practices, it's easy to see parallels with New Zealand. The British government not only funds and regulates public services; it owns, supplies and purchases them itself. This means there are no competitive pressures to drive up standards, no choice for most consumers, and no price signals in the system. "Instead we ration by queuing," says Gent. "We add to the bureaucracy and inefficiency of the services by monitoring through costly and distorting targets." Successive governments have boosted spending and tightened central controls but without disturbing the status quo and to little avail.

Gent argued that the only answer to the fundamental problems of key public services was radical structural reform. "The absolute bottom line of such reform must be to break monopoly and liberate the supply side... The problem with the government's public sector reform programme, against which much additional taxpayers' resources are being spent, is that it essentially maintains public monopoly." Too often, the government and not the real consumer remain the

purchaser of services: “this half-hearted approach is not the best way to unlock enterprise.”

The principles of choice and competition cannot apply to true ‘public good’ services such as policing, but there is no reason why the state has to supply healthcare, education and transport “any more than it attempts to supply other essential aspects of life such as food and clothing.”

Critics argue that if the market were used to deliver public services it would create a two-tier system. Gent’s riposte is that the current system is fundamentally inequitable: “Today it is the least well off who tend to ... endure the worst schools, the highest levels of crime and the poorest healthcare.”

Gent rejected incentivised opt-outs, which are currently in vogue with Britain’s conservative politicians. These, he said, would benefit the few and leave the fundamental structure of service provision unchallenged.

The Labour government has been trying to promote change. Last year prime minister Tony Blair said he wanted it to “be far more radical about the role of the state as regulator rather than provider, opening up healthcare for example to a mixed economy under the National Health System umbrella ... [to] stimulate new entrants to the schools market, and be willing to experiment with new forms of co-payment in the public sector.”

If Blair’s government – or any that replaces it – pursues real reform, Gent says “the public services could be taken off the escalator of ever rising public expenditure.” Britain could have both better outcomes and lower taxes. Parents and patients would have more real choice, while working conditions for public service staff would improve because they would be accountable “to parents and patients, not bureaucrats.”

In New Zealand, education, health (or more precisely, hospitals) and welfare, together with electricity and roading, remain the main state-dominated parts of the economy. They also stand out as sources of community dissatisfaction.

In the 1980s, there was similar dissatisfaction with shoddy and over-priced goods produced by New Zealand manufacturers, the terms of access to mortgage finance, poor service by airlines, six-week waits for telephone connections, queues for taxis, and much more. Most of this dissatisfaction has dissipated as choice and competition were introduced and governments pulled back from regulating and running businesses.

Lord Beveridge, one of the architects of Britain’s National Health System, saw it as taking Britain “halfway to Moscow.” Former US teacher union president Albert Shanker once said, “It’s no surprise that our school system doesn’t improve: it more resembles the communist economy than our own market economy.”

There has to be a better way. As Gent argues, a failing public sector monopoly is not a national treasure.*

*First published in *The Otago Daily Times* on 26 March 2004.

Is the labour market special?

It is extraordinary to find people who believe – or at least used to believe – that the labour market is somehow 'special' (in an economic sense) and that employment contracts need to be regulated differently from other contracts.

Thus Colin James, then editor of the *National Business Review*, described the Business Roundtable's push for what became the Employment Contracts Act as "pretty theorising," "purist," reaching for a "fanciful degree of freedom" and painting "a make-believe world in which workers choose between competing unions in their workplace or even negotiate their own wages."

Make-believe? Today, nearly one worker in ten in the private sector negotiates their own wages through individual contracts.

At the heart of the debate about the Employment Relations Act and the proposed changes to it is the Margaret Wilson view that there is "unequal bargaining power" between firms and their staff, which necessitates unionisation, collective bargaining and special rules.

This idea is fundamentally Marxist – Marx saw the world as a class struggle between workers and owners of capital. But it is easy to show it is wrong, both empirically and in theory.

Empirically, if employers had systematic bargaining power, wages would never rise. Indeed a wage of, say, $20 an hour would be driven down to $15 then $10 and then to a bare subsistence level. That is exactly what Marx thought would happen. But of course real wages rose strongly even in Marx's lifetime in the developed world, and have done so ever since.

Another empirical test: if Ms Wilson were correct, high wages would depend on high levels of unionisation and collective bargaining. But there is no such relationship. Hong Kong is a country where unions hardly exist yet wage levels are among the highest in the world.

What is wrong with the Marx/Wilson theory? It is simply that the adversarial view of employment relations is fallacious.

Firms (buyers of labour) compete with other firms for staff and workers (sellers of labour services) compete with one another for jobs. As in any other market, sellers do not compete with buyers. Wages are driven up by productivity increases and competition for scarce labour.

At times there may be a buyer's market or a seller's market for particular skills in particular locations. But this is no different from what happens in other markets (like housing). Bargaining 'power' depends on the alternative opportunities available to parties on both sides of the market.

Other fallacies follow from the initial misconception. For example, unions complain about 'take-it-or-leave-it' offers, not recognising that we face

take-it-or-leave-it transactions every day, such as when we deal with a bank or a supermarket. Any other way of closing a transaction would indeed be the stuff of a make-believe world. But neither workers nor consumers are exploited in competitive markets: people who can go elsewhere are very hard to exploit.

The idea of inequality between firms and workers in setting wages is the hoariest of myths.

We need sound, normal laws of contract to ensure fair employment bargains are made and enforced, but Marxist labour theories should be consigned to the dustbin of history.*

*First published in *The Dominion Post* on 1 March 2004.

A refreshing return to sanity

Remember the New Economy? *Unlimited*'s first edition in 1998 heralded the new age: "This Way to the New Economy." The National government was emoting about New Zealand's knowledge-based 'Bright Future.' Later the Labour-led government jumped on the 'Knowledge Wave' bandwagon.

Commentators like Rod Oram and Howard Frederick were forever telling us that New Zealand was too dependent on commodity exports and should move to higher value-added products – as Frederick put it, "If we don't do something now we may doom future generations of our country to a pastoral subsistence."

New Zealand's future, it was said, was in 'hi-tech' industries. Dotcoms were driving booming world sharemarkets; the New Zealand sharemarket was a dog: "The old economy is dead and its graveyard is the NZSE" (*Unlimited*, July 1999). It was 'E' with everything. Incubators! Flying Pig! Day Trading! The New Capital Market! Harvard 'guru' Michael Porter joined in the hype (though he later decided 'picking winners' didn't work). The Business Roundtable's line was "boring"; it should stop "whinging" about bad policies. As recently as June 2000, *Unlimited* was assuring us that "The new economy is real, big and trucks on as far as the eye can see."

What a difference three years makes! In a refreshingly open editorial on the New Economy (*Unlimited*, Dec 2003/Jan 2004), Vincent Heeringa acknowledged, "These days, no one dares speak its name."

With the dotcom collapse and the international downturn of the early 2000s, a measure of sanity has returned. Having avoided the excesses, the New Zealand economy weathered the downturn well. Taking the last 10 years as a whole, it was the 7th best performer in the OECD, thanks largely to the structural reforms of the 1980s and early 1990s.

Since the world sharemarket falls, the New Zealand sharemarket has outperformed most others. Business-bashing ("Our top companies are looking like old tarts at a teenage pool party" – *Unlimited*, Sept 1999) took a knock as New Zealand management and corporate governance performance was seen to compare favourably with scandals abroad. As Roderick Deane told *Unlimited*, "the knowledge wave conferences were a great diversionary activity" which was exploited by the government, but little of substance eventuated. The latest OECD report on the New Zealand economy urged the government to refocus on the economic fundamentals.

Much of the talk about the New Economy and the Knowledge Economy showed an embarrassingly weak grasp of economics.

There is nothing new about the role of knowledge. Knowledge has mattered for economic progress ever since hunters and gatherers left their caves. Peter

Drucker was writing about 'knowledge workers' 50 years ago. Sure, education is very important, but the Soviet Union had excellent scientists and engineers and was an economic basket case. We might well be better off if some people left school earlier and did old-fashioned trade apprenticeships, and if some did not proceed to university studies for which they are not well-suited.

The animus about commodities is mistaken. What's a commodity? McDonald's burgers, Starbucks coffee and Easyjet's budget airline seats are surely commodities but these businesses have made great wealth for investors. Australia, with over 50 percent of its exports in commodity form, has been one of the world's best performing economies. We become poorer, not richer, if firms make less money from wood processing than from log exports. All we need to concentrate on is what is most profitable at world prices, ie adds most to GDP.

Some commentators still write about R & D as if it were some magic bullet for growth. But there is no correlation across countries between R & D expenditure and economic growth rates. New Zealand firms have spent more on R & D as the economy was opened up to competition. The latest OECD figures put spending on R & D in New Zealand at 1.03% of GDP, not far short of Ireland at 1.17%. What matters more than R & D spending is innovation, and there is no evidence that New Zealand firms are innovation laggards. And just because some of a thing is good, it doesn't follow that more is better, or that we should subsidise it.

Now that the New Economy fever has subsided, what are the lessons to be learned?

One is that armchair commentators should show a little more humility. Too often they write as though New Zealand business people are dumb or irrational in failing to spot opportunities. In an economy open to the world, they should recognise that there is nothing to stop others entering the market and doing better, or indeed to stop them putting their own money where their mouth is.

Another lesson is that structural changes in an economy occur slowly. As former MAF policy director Robin Johnson tried to explain three years ago, tomorrow's exports will be much the same as yesterday's (*Unlimited*, Dec 1999/Jan 2000).

A third is that the laws of economics don't change. They apply to the so-called New Economy just as to the old. It is extraordinary how many pundits, even ones based in universities, write about economic matters without the slightest reference to basic economics and research on how economies operate and grow. A nodding acquaintance with the volume of economic literature on growth now available – which points to the paramount importance for prosperity of the quality of a country's institutions and policies – might spare them from embarrassment when the next economic or business fads and fashions come round.

In the meantime, New Economy – RIP.*

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An outsider's perspective

Sometimes, seeing your own situation through an outsider's eyes can provide an interesting perspective. Last weekend an Australian business leader delivered the keynote speech at the New Zealand Business Roundtable's annual retreat.

Hugh Morgan is the president of the Business Council of Australia – an organisation of CEOs of major companies that, roughly speaking, is the Business Roundtable's equivalent across the Tasman. Morgan was CEO of the former Western Mining Corporation from 1990 to 2003, and is a member of the board of the Reserve Bank of Australia.

Morgan first reported on developments in the Australian labour market. It was a story that is familiar to New Zealanders. Previous hard-won advances in labour law – creating more flexible and freer regimes in which workers and employers could negotiate their own terms – had stalled or been overturned. In Western Australia, what Morgan described as the best regime in the country had been repealed by a new state government.

As in New Zealand, unionism in Australia is becoming less relevant. Morgan told his audience that "it is clear from the continuing decline in union membership (at least in the non-government sector) that public support for the 'system' continues to ebb away, most notably amongst young people." In the face of this trend, interventionist-minded governments on both sides of the Tasman are attempting to use ever more restrictive legislation in the (probably vain) hope of sustaining union membership.

At the federal level in Australia, opposition leader Mark Latham has warned that casuals will lose their rights to be casual, despite this being an option which often provides higher pay and greater flexibility than so-called 'permanent' employees. Also on the Australian Labor agenda is an increasing attack on contractors and sub-contractors, a group which, with self-employed people generally, now comprises 28 percent of the workforce and is growing rapidly.

Morgan reported that in South Australia, a Labor state, some quite extraordinary legislation is proposed which seeks to change the law of contract as it operates in the world of business and commerce. The ambition behind this revolutionary bill is to turn every contractor into an employee.

However, Morgan saved his sharpest criticism for our government's proposed changes to the Employment Relations Act. He said: "The current NZ government seems intent on thoroughly gutting the Employment Contracts Act of 1991, a reform which gave NZ the most efficient, and one should add, the most labour-friendly, labour market within the OECD, perhaps in the world. It is a matter of deep regret that such a great reform should last for only 13 years,

and it is a sharp reminder that there are no permanent gains in politics. The price of freedom, in this case freedom in the labour market, is eternal vigilance."

Morgan staunchly defended the legitimacy of a business voice on public policy: "I see no reason why a business organisation cannot argue consistently and confidently in support of prosperity and in support of government policy that will sustain prosperity rather than diminish it."

He observed that our business communities had generally moved away from "old style rent-seeking" – looking for government favours – and noted that the focus of organisations like the Business Council of Australia and the New Zealand Business Roundtable was the national interest, "in the broadest possible meaning of that term." That requires such organisations to enter into debates ranging over such things as poverty, welfare, education, crime and constitutional affairs, because a healthy business environment must go hand in hand with a fair, healthy and well-governed society.

Morgan pointed out, however, that some in business are happy to keep their heads down and free-ride off the efforts of others. They say things like "reform is not my problem" and "playing a public policy role is certainly not in my interest, nor in my company's interest."

We have seen this behaviour in New Zealand too: the heads of some businesses that have only prospered because of reforms which nave made the economy far stronger and opened up new opportunities (eg to import goods at lower costs) have done little to defend or advance them. Fortunately, we have also had business leaders who have been less self-serving and who have joined representative business organisations and spoken out themselves, often in the face of controversy and criticism.

Morgan observed that in both Australia and New Zealand, "the passion for moving forward with a reform agenda aimed at improving prosperity and competitiveness seems at the moment to be extinguished – or at least quiescent."

But he noted that events can happen that change the country's mood dramatically, as we have seen recently over Treaty issues. Meanwhile, he concluded, "the hard slog of argument and debate has to continue."

As our current government steers a path of slowly undoing many of New Zealand's 20-year-old economic reforms, damaging the country's medium-term growth prospects (as its own projections are confirming), those messages are particularly relevant.*

*First published in *The Otago Daily Times* on 27 February 2004.

Australia-US trade deal spells danger for New Zealand

Four years ago, New Zealand wanted to join Australia in a quest for a three-way free trade deal with the United States. As one commentator described subsequent events, "Australia judged New Zealand a political liability and cut its neighbour adrift."

The two South Pacific countries took divergent paths. Australian prime minister John Howard made a security alliance with the world's sole superpower the centre of his foreign and defence policies. Prime minister Helen Clark has tended to look to Europe for a lead, rather than to traditional allies.

The New Zealand government held out hopes of riding on the coat-tails of Australian efforts to get a free trade agreement with the United States. It sought to argue that the Australia New Zealand Closer Economic Relations Agreement (CER) meant any benefits from a trade liberalisation deal should flow on to New Zealand.

After eleven months of negotiations, president George W Bush and John Howard have announced that their countries have formulated a free trade agreement that includes:

- immediate, free and open access to the US market for Australian exporters of almost all manufactured goods and services;
- duty-free access from day one for over 97 percent of Australia's manufacturing exports to the United States, worth NZ$6.5 billion last year;
- reducing more than 66 percent of agricultural tariffs to zero from day one;
- full access for Australian goods and services to the NZ$300 billion market for federal government procurement in the United States; and
- enhanced legal protections that guarantee market access and non-discriminatory treatment for Australian service providers in the US market.

Australian consumers will benefit from greater choice and competition. Freer trade will be associated with freer investment flows. New Zealand will forgo these benefits. Past economic modelling for the Treasury projected that a US-Australia free trade deal would reduce New Zealand's national income and have a negative impact on foreign investment flows.

The historic importance of the agreement is that it will help Australia further improve its competitiveness and become a freer, more dynamic economy.

Australian economist Wolfgang Kasper said last year that the country's "long, hard climb up the economic freedom ladder has stalled." The biggest handicaps, Kasper said, were the burden of government and artificial restrictions on Australians being able to use their labour and talents freely. "The best hope that these handicaps will be redressed and Australia's flagging commitment to economic freedom will be revived lies in the prospective economic integration agreement with the United States… The growing integration with the relatively free US economy will make further reforms and competitive attitudes imperative."

Such benefits would also be extremely significant to New Zealand, were it to secure an FTA with the United States. At a time when economic reform has been stalled or reversed, an agreement could trigger a new willingness to adjust and compete. A closer association with the world's pre-eminent economy might be a transmission belt for some of the things that make America such a successful country – its attachment to constitutional democracy, support for limited government and individual freedoms, respect for property rights, entrepreneurial culture, business skills, flexibility and dynamism.

Last May, however, the US embassy made it clear that New Zealand should not expect a deal any time soon.

"The United States is not prepared to enter into FTA negotiations with New Zealand at this time," it said bluntly, "though we have not ruled out the possibility of an FTA … at some point in the future."

What would it take for New Zealand to secure its own agreement? US decisions on trade agreements are based on a wide range of factors including trade, political, security and other elements of the bilateral relationship. The message coming from Washington seems to be that New Zealand must expend some political capital if it wants to make progress.

Foreign affairs minister Phil Goff has said the integration of the Australasian economies means US negotiations with New Zealand will in due course be a logical step. However, it is impossible to ignore geo-political considerations.

New Zealand's failure to date to secure an FTA is not the end of the world, but end-of-the-world scenarios are not the relevant ones to contemplate. In economic life, no single policy misstep – an increase in the tax rate here, a reversal of labour market deregulation there – is in itself the end of the world. But the costs of a series of missteps or a series of missed opportunities mount up over time.

The government has chosen to take New Zealand down a path that takes it away from old allies, and towards European-style international relations, welfare, labour market and environmental policies. Europe's big economies are uncompetitive and struggling to grow. If New Zealand is to achieve long-term sustainable growth, current directions must be called into question.*

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*First published in *The Otago Daily Times* on 13 February 2004.

Asian giants on the rise

China and India are now major forces in the world economy.

Since it set out on the 'capitalist road' 20 years ago, China's growth has been phenomenal. But India's growth rate is now close to matching China's: both economies grew by 8–9 percent last year.

Per capita incomes in China and India are now US$4,390 and US$2,570 respectively, according to World Bank figures (PPP basis). In the past two decades, millions of people in these countries have been lifted out of poverty.

Economic reform continues apace in China with the closure or privatisation of state-owned enterprises, moves to enshrine stronger legal rights to private property, and entry into the World Trade Organisation.

In a symbol of globalisation, the site in Shanghai where the Communist Party was founded is now a shopping and entertainment complex, anchored by a Starbucks coffee shop.

India's economic directions now seem secure. In this year's elections the government will campaign on a platform of 'India Shining' but a change of government would mean little change in economic direction. The business community and much of the media are pressing the government to liberalise faster.

China is already a dominant force in labour-intensive manufacturing. India has internationally competitive IT and pharmaceutical industries as well as a large, well-educated, English-speaking labour force.

The rise of China and India is often seen as a threat to investment and jobs in Western countries, including New Zealand. But New Zealand will clearly benefit if these countries grow richer and become larger markets for what we produce, rather than stay poor.

The economy is far better structured to benefit from these new sources of growth than when it was protected and rigid. The opportunities will be not only for sophisticated goods and services but also for food, intermediate goods and commodities.

Contrary to commentators such as Rod Oram and Vincent Heeringa, the terms of trade outlook for resource-based products seems favourable. China's terms of trade fell by 30 percent in the past decade as productivity growth drove down the relative price of its exports, whereas New Zealand's remained much more stable. There is nothing wrong with profitable production of commodities.

But to compete and prosper, New Zealand will have to be flexible and competitive, and match trends in Asia and elsewhere. There is little prospect of China and Asia developing welfare states. After years of free housing, health care and education, most Chinese now pay for some of these services. In India,

parents are abandoning the government school sector. Tax rates are likely to fall, and India's top income tax rate of 30% is already below New Zealand's.

China and India face huge challenges: bureaucracy and corruption in both, a shaky banking system in China, and many others. China's regime is resistant to notions of democracy and human rights.

But my guess is that what beckons for both countries is ongoing economic liberalisation and development and political democratisation, because they beckon for countries the world over.*

*First published in *The Dominion Post* on 9 February 2004.

Memo to Margaret Wilson: please engage

Writing in the *New Zealand Herald* on 23 January 2004, labour minister Margaret Wilson made a plea for engagement with the bill amending the Employment Relations Act as it is considered by a select committee: "I am genuinely interested in the submissions."

Well, engagement is obviously a two-way process. So let the engagement start.

Ms Wilson will have to work hard to demonstrate her genuineness. Her track record for listening to business and other opposing views is not good.

Discussing the proposed abolition of appeals to the Privy Council, Ms Wilson told *The Independent* (10 October 2001): "The business community must be confident with the outcome... We need maximum agreement if there is to be any changes." Yet the overwhelming weight of submissions from the business community was against the Supreme Court Bill, there was no engagement, and Ms Wilson steamrollered it through.

Similarly, Ms Wilson introduced the Corrections Bill ending private management of prisons in New Zealand. The decision is ideological and union-driven. Ms Wilson's argument that prisons are a core public service and must be administered by the state doesn't hold water. Constitutionally, it is perfectly appropriate for prison operations to be contracted out on terms set by the government, as many countries do. Thirty out of 41 submissions on the bill – many from Maori and Pacific groups – opposed the proposal, yet there is no sign that the government is listening.

In the case of the amendments to the Employment Relations Act, the government has had extensive discussions with unions but no comparable consultations with the business community.

Against this background, many in business are likely to question Ms Wilson's open-mindedness. Never mind: we should hope a minister of the crown can be taken at her word.

The starting point for engagement should be the fundamental idea running through the bill and the Employment Relations Act. This is that labour markets are special; are characterised by unequal bargaining power between employers and employees; and require special regulation to promote unionisation and collective bargaining to offset this inequality.

The idea of unequal bargaining power has been asserted but never explained by Ms Wilson. As a former law professor, she must know it has been refuted by a vast body of law and economics scholarship.

The idea owes its origins to Marxist economics. Marx saw the world in terms of a class struggle between workers and owners of capital. Employers had the

upper hand and would 'exploit' workers. The wages of workers would be driven down to subsistence levels, and they would become "wage slaves."

Facts soon demonstrated that Marx was wrong. Wages rose strongly even in his lifetime. In the modern era, Hong Kong is a country where unions hardly exist but wage levels are among the highest in the world.

The fallacy in the notion of unequal bargaining power is obvious. As University of Chicago legal scholar Richard Epstein has put it:

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

In competitive labour markets, the reality is that employers compete with one another for workers, and workers compete with one another for jobs. Wages are driven up by productivity increases and competition for scarce labour. At times there may be a buyer's market or a seller's market for particular skills in particular locations. But there is no systematic advantage for one side over another, otherwise wages would never rise, and there is nothing special in any relevant economic sense about employment contracts.

So in the interests of engagement, my first question to Ms Wilson is:

Question 1: What is the *theory* and *evidence* behind your view of unequal bargaining power?

Marx's fallacy led him to propose collectivist responses, of which unionisation is one. There can be no objection to voluntary unionism, but unions are becoming less and less relevant in the modern economy, and rates of unionisation are dropping worldwide. Often unions hinder rather than help the productivity growth on which increases in wages depend. Unions no longer represent workers at large: only 1 in 5 New Zealand workers now belongs to a union, and unions are disgruntled that this ratio has not increased despite the privileges granted to them in the ERA. The law firm Simpson Grierson notes, "Unquestionably, the Bill provides a significant boost to the union movement," and Ms Wilson is on record as saying she would like to see 30% of workers in unions. But why?

Question 2: Why do you want to push some 200,000 more New Zealand workers into unions?

The bill also aims to boost collective bargaining; Simpson Grierson says "The right of employers to say 'no' to a collective agreement is also significantly curtailed." Employees' freedom to choose between individual and collective agreements is equally affected. The government has said it wants to double the number of workers on collective agreements but most workers prefer individual contracts which recognise their diverse needs, interests and performance. There are no sound public policy grounds for trying to tilt the playing field towards collective bargaining. So my next question is:

Question 3: Why are you against allowing an unbiased choice between individual and collective agreements?

Not only does the bill aim to foist collective bargaining on individual employers, it also seeks to push firms into multi-employer agreements. Any employer who is asked must attend at least one meeting and demonstrate good faith. If no agreement is reached, and the Employment Relations Authority decides there is a breach of good faith, such an agreement may be imposed.

This carries collectivism to new heights of absurdity. There is nothing wrong with firms in an industry coming together to negotiate a broad agreement, but most don't want to. Most want to deal directly with their own employees, and vice versa. The basis of this provision is transparent. The Council of Trade Unions (CTU) in its submission on the ERA review made it clear that its ultimate agenda is "a return of the [national] award system." So much for the protestations of 'new breed' unionists that they don't want to return to the old days.

Question 4: Why does employment law need to say anything about multi-employer agreements, let alone promote them?

Clause 6 of the bill creates a new duty of 'good faith' which "requires the parties to an employment relationship to be active and constructive in establishing and maintaining a productive employment relationship in which the parties are, among other things, responsive, communicative and supportive."

As US labour expert Charles Baird has written, "Wow! That is sufficiently mushy to sustain just about any allegation of breach by any employer who does not want to cave in to union demands." The provision arises because the CTU did not like a Court of Appeal decision that 'good faith' was no different from the implied common law term of mutual trust and confidence in other economic relationships. And why should it be different? We expect 'good faith' when we are buying a house, selling a business or conducting

any number of transactions that may be more significant than making or changing an employment agreement.

Question 5: Why do you wish to overrule the Court of Appeal and apply a different standard of trust and confidence in the employment context?

The bill provides that all employment contracts must include provisions that ‘protect’ workers when their existing employer sells or transfers ownership of a business or contracts out any jobs. In some cases it requires employment conditions to be maintained or redundancy to be negotiated or imposed. Workers are not protected by measures that make it more likely that a firm will fail rather than be taken over or reorganised. As Professor Baird notes, “This will do wonders for flexibility of organizational architecture in response to frequently changing market conditions in the global economy.”

Question 6: How does this provision – and indeed the bill as a whole – square with the government’s “top priority” goal of getting New Zealand back into the top half of the OECD income rankings?

A specific objective of the review of the ERA was to reduce compliance costs. The ERA has already been a source of increased compliance costs for business. Far from reducing them, another 59 pages of amendments, such as those relating to ‘good faith’ bargaining, multi-employer agreements, contracting out and the sale of a business, will clearly increase compliance costs, as other ministers have acknowledged.

Question 7: What happened to the aim of reducing compliance costs in the ERA review?

The review of the ERA was not supposed to be about delivering a union wish-list. The government said it wanted views on its operation from employers as well. There is little, if any, sign in the bill that their views have been listened to.

Given that the review was not a back-to-basics exercise, submissions from business were limited in scope. One straightforward one is that unions should not have a monopoly on collective bargaining. Under the ECA, human resources firms, lawyers and others could also act as bargaining agents. The government has never even tried to justify what appears to be a blatant privilege to unions.

Question 8: Why should other agents not be allowed to negotiate collective agreements?

Another submission from business quarters is that there should be a probationary period of, say, 3 months before personal grievance provisions

apply. The reason for this is to give marginal workers – people whom employers might otherwise regard as too risky to take on – a chance at a job. This is another case of union interests – which are to restrict entry and cartelise the labour market – diverging from those of workers and the broad social interest. Probationary periods are commonplace in other jurisdictions.

Question 9: Will you listen to the case for a personal grievance-free period of employment?

Short of allowing personal grievance provisions to be a matter of voluntary negotiation, business groups have argued that there should be a salary bar of, say, $50,000 to their application. It can hardly be argued that skilled and well-qualified people are unable to look after their own interests and negotiate such provisions in their contracts if they so wish. The public has been rightly outraged by enormous payouts which firms have had to make to failed chief executives and senior managers when they fired them.

Question 10: Will you agree to a salary bar on personal grievance claims?

The government has also justified the bill by appealing to the need to conform with international thinking or labour issues as reflected by the International Labour Organisation. But the OECD, representing the balance of opinion of the world's most advanced countries, had no problem with the ECA: it reiterated in 1999 that "the framework of labour market regulations in New Zealand is sound" and it has criticised the government's subsequent moves and present plans. Too much of the ILO's thinking still inclines towards European-style labour law which contributes to the rigid, sluggish economies and high unemployment rates of Europe.

Question 11: Why do you favour the views of the ILO, which represents many of the world's least successful countries, over those of the OECD on what constitutes sound labour law?

In the interests of promoting public understanding and debate on employment law and other public policy issues, the Business Roundtable is bringing Professor Richard Epstein to New Zealand this year. He is an eminent authority on labour issues, and knows the New Zealand context well.

Question 12: As a form of engagement, we would like to invite you, as a fellow (former) law professor, to take part in a public debate on the ERA in a university or similar setting. Will you agree?

Answers to those questions should provide a good platform for pursuing the 'constructive engagement' which the minister has called for. She has made much of dealing in good faith. I look forward to her response.*

*First published in *The Independent* on 4 February 2004.

Employment law changes a blast from the past

The prime minister's goal for New Zealand is to return average incomes to the top half of the OECD range and get the unemployment rate down to 3 percent. As 2004 begins, these goals are not in sight.

The government's own figures show that the growth rate of the economy is likely to fall away relative to the better performance of the last 10 years. In the five years from 1991, the unemployment rate fell from 11 percent to 6 percent. In the subsequent seven years it drifted down to 4.4 percent and is not predicted to fall further, and the Maori unemployment rate remains a totally unacceptable 10 percent.

In December, finance minister Michael Cullen was asked to write an article explaining how the Labour government would make 2004 a great year for business. His message in part was that: "The Government is not the main determinant of business success or failure and has duties which extend beyond simply driving down the costs of business."

That is correct, but the role of government should not be underestimated. Politicians and policy makers set the framework in which businesses operate. Whether firms are operating in an environment like that of, say, South Korea rather than North Korea, makes a world of difference. Several moves planned by the government for 2004 will make the environment less attractive to New Zealand entrepreneurs, employers and investors.

The first on the horizon is the Employment Law Reform Bill, a ratcheting-up of the Employment Relations Act. The new bill would not make the sky fall in – but it would amount to death by a thousand cuts. It would reduce the freedom of employers and employees to make arrangements that suit them. It would push workers into collective agreements instead of individual agreements. There is also an attempt to force business owners into multi-employer agreements, and to redefine 'unjustified dismissal' in a broader way. The bill is complex, poorly drafted, and legalistic; only lawyers and unions stand to benefit from it.

The legislation would make meeting the prime minister's goal even harder to reach – and that would have real consequences. Wages would be continue to be lower than in the countries that attract a generation of young New Zealanders. Investors would be deterred, meaning less money would be spent employing New Zealanders.

Although trade union leaders publicly maintain they have 'moved on' and don't want to go back to the bad old days, in fact their agenda is little changed. In submissions to Margaret Wilson, the Council of Trade Unions declared its "interest in more fundamental measures such as a return of the [national] award

system" and in compulsory arbitration. The bill already contains many devices to push workers into unions – shades of compulsory unionism.

National Distribution Union president Bill Andersen has delivered a clear warning: "For those employers now party to collective agreements ... the proposed amendments will not cause the substantive changes that the business leaders and the business commentators are forecasting (e.g. loss of jobs)." In other words even Mr Andersen acknowledges that for other firms, which employ 80% of the workforce on individual contracts, the proposed amendments will indeed have harmful consequences.

After failing to consult employers before sending the legislation to parliament, Margaret Wilson now wants to "engage" with business. Given the strength of business disquiet, engagement is likely to occupy a lot of time this year.

The Bill comes on top of a raft of legislation that has increased the costs of doing business and tied up employers in ever greater amounts of red tape, including changes to OSH, the Holidays Act and the introduction of an extra week's annual leave. Next in the pipeline are so-called 'pay equity' and initiatives to improve 'work-life balance' – the latest fad taking up the time of Wellington policy makers.

The Department of Labour has dedicated an entire website (www.worklife.govt.nz) to what it calls "WLB."

"What is WLB?" the website asks itself. It is "about effectively managing the juggling act between paid work and the other activities that are important to people." WLB "is a very personal thing and will change for each person at different times of their lives." It would be indelicate to suggest WLB could also stand for "What a Load of Bull."

Getting the balance right between work and non-work commitments is important – that is simply common sense. But the idea that the government has a role instructing individuals in this matter is difficult to stomach.

If it were truly committed to the goal of returning average incomes to the top half of the OECD range and achieving an unemployment rate of 3 percent, the government would set up a flexible and open framework and then follow the advice given by France's business people over two centuries ago: laissez-faire – leave us alone. Instead, taking the Chinese Year to heart, the government appears committed to further monkeying around with the business environment in 2004.*

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*First published in *The Otago Daily Times* on 30 January 2004.

Growth and innovation: yeah right!

To borrow a phrase, there seems to be some sort of compact between the government and the trade union movement to "lie in unison" about business reactions to proposed changes to employment law.

Labour minister Margaret Wilson and the Council of Trade Unions have been reciting the mantra that business claimed the Employment Relations Act (ERA) would see "the sky fall in" and that the "spinners of doom" would make similar predictions about the latest proposed employment law changes.

What did business representatives actually say?

Speaking for the Business Roundtable, my assessment was that "the overall basis for judging the ERA is not whether it has caused the sky to fall in but whether it risks causing death by a thousand cuts." I added that "The acid test of whether this assessment is right is whether the ERA and associated changes will achieve the prime minister's goals for New Zealand of average incomes in the top half of the OECD range and an unemployment rate of 3 percent."

These goals are not in sight. On the government's own figures, the growth rate of the economy is likely to fall away relative to the performance of the last 10 years. In the five years from 1991, the unemployment rate fell from 11 percent to 6 percent. In the subsequent seven years it drifted down to 4.4 percent and is not predicted to fall further, and the Maori unemployment rate remains a totally unacceptable 10 percent.

Those misrepresenting history would do well to recall their own earlier predictions.

The Council of Trade Unions told us that the Employment Contracts Act (ECA) would lead to "anarchy" and "the Pol Potisation of the union movement." Wages would collapse and later they would explode. Margaret Wilson, then a law professor at Waikato University, said the ECA denies workers "the means to organise to protect their collective interests."

Ms Wilson's predictions have not got any better. She predicted less industrial disruption under the ERA. Days lost in disputes have increased.

Partly because firms and workers valued the freedoms created by the ECA, partly because the ERA remains enterprise-focused, and partly because some of the worst features of the original bill were watered down, the impact of the ERA has been limited. Even so, a survey in the *NZ Journal of Industrial Relations* found that nearly a third (28 percent) of employers regarded the act as having a negative effect on their businesses.

What the ERA has not done is boost union membership and collective bargaining to any extent. But there is no reason for either to be favoured – as opposed to being a matter of choice. Only one worker in five now belongs

to a union in New Zealand; most want to be treated as individuals rather than as parts of a collective 'lump of labour.' Ms Wilson's goals of increasing union membership to 30 percent of the workforce and doubling collective agreements have no rationale other than to appease union bosses.

The contrast with British politics could not be starker. Tony Blair has all but broken the umbilical cord between the union movement and the Labour Party, and kept in place the Thatcher government's labour law reforms.

Despite their 'new age' pretentions, the unions' agenda hasn't changed: it is to strengthen union power by moving employment arrangements back towards the old days of compulsory unionism, compulsory arbitration and multi-employer contracts – all artefacts of the class-warfare conception of employment relations. Elements of these, plus more European-style employment protection rules, feature throughout the new proposals.

None of this is in the interests of firms, workers and the unemployed. A World Bank study in the 1980s found that countries with inflexible labour markets suffered a penalty of 1.4 percentage points in their annual growth rates, a massive sacrifice in potential wage growth over a worker's lifetime. Despite their shortcomings, the OECD commended New Zealand's earlier labour market reforms and has criticised the government's moves.

Contrary to the government's claims that it is "listening to business," there is no sign of it in the new bill. Even modest proposals like the removal of the union monopoly on collective bargaining, a probationary period before personal grievance provisions apply, and a salary bar on unjustifiable dismissal claims have been ignored.

The government knows that its claims to being serious about growth are a charade. Recognising that its employment law changes, including an extra week's holiday, are negative for productivity and growth, it has been talking about setting up a productivity council to give advice on how to offset their effects!

The *Herald* had it exactly right in a recent editorial. Further steps to ossify our labour market won't cause the sky to fall in. Rather, "The country will pay the price in a little less competitiveness (from multi-employer agreements), a little less employment by small and medium-sized firms (obligations in the event of sale) and less confidence among investors that this is a country which rewards energy and enterprise."

Who in their right mind would want to go down that path?*

*First published in *The New Zealand Herald* on 22 January 2004.

Prejudice against a word

"Never speak to me of profit," mid-twentieth century Indian leader Pandit Nehru once said to an industrialist. "It's a dirty word."

American economist Thomas Sowell claims that attitude cost millions of people a better life.

When severe restrictions on Indian business were finally lifted, economic growth picked up. Incomes rose along with employment and tax revenues. "This poverty-stricken country could have had all those things 40 years earlier, except for a prejudice against a word," Sowell says.

Opposition to profit reflects a fundamental misunderstanding of how the economy works, and how people's living standards are raised. The drive for profit provides us with jobs, goods, services and an industrial society more prosperous than anything our ancestors could have even dreamed of.

Profit performs two main functions. First, whether or not a business earns a normal profit indicates whether resources are efficiently allocated – whether the business is creating or destroying wealth. Sustained losses indicate society would be better off if the firm's resources were allocated to other uses or taken over by other managers.

Second, profit provides a reward for successful innovation. Most new products fail the test of the marketplace. Those that do succeed may earn temporarily high profits until other producers enter the market. The process drives prices down and increases consumer choice.

The economically illiterate see profits as unnecessary. They look at a company that makes a million dollars in profit, and deduce that its products could have been that much cheaper without the profit element. In reality, those products might have cost several million dollars more to produce without the incentives to be efficient created by the prospect of profits.

Many large fortunes have come from finding more efficient ways to produce a product or service at a lower cost, so that it could be sold at a lower price and attract more customers. Making a fortune does not represent greed, which we rightly condemn. It represents the reward for successful entrepreneurship, obtained by benefiting other people.

Individual companies are sometimes criticised for laying off staff or hiking prices to stay profitable. They are accused of putting 'profit before people.' But consider the alternatives: a firm that fails to adjust will go out of business altogether, leaving its entire workforce without jobs. Small investors in the firm will lose their savings. The firm's profits belong to people – around half of us in New Zealand own shares, either directly or through unit trusts or superannuation funds.

If we care about people, we should beat up on loss-makers, not profit-makers. Adam Smith, who popularised modern economics, said of each member of society that, "by pursuing his own interest he frequently promotes that of society more effectually than when he really intends to promote it."

Those who claim to promote a lesser role for profits or an end to global capitalism are actually advocating greater government control of resources.

If we learned anything from the twentieth century, it was that people's interests are better served by less government and by more market-based wealth creation. After socialising agriculture, countries which for centuries had exported food found themselves forced to import goods to stave off starvation. Soviet industry used far more resources to produce a given output than market economies like Germany, Japan or the United States.

Ask opponents of profits whether they would rather get dental work from a dentist in a capitalist nation or a socialist one. In the latter, the state rations out 'free' healthcare services. The result is a lack of consumer choice and competition – the ingredients that provide an incentive to improve quality under a market system. Croatian author Slavenka Drakulic said after communism's fall in the former Yugoslavia that "dental care has been free for over forty years" with the result that "the whole nation had bad teeth." The outcome of socialism is the opposite of the intent.

Government provision in market economies is often not much better. In Canada the courts recently ruled that patients suffering from AIDS, cancer and other diseases are entitled to enjoy the benefits of 'medical marijuana,' supplied by the government health system. Of the first ten patients to be supplied with the government product, half claimed it was the worst pot they had ever smoked, and sent it back to Ottawa demanding a full refund. Commenting on this episode, columnist Mark Steyn said, "one of the reasons I'm in favour of small government is because there's hardly anything the government doesn't do worse than anybody else who wants to give it a go."

What we call the market is really a democratic process involving millions, and in some markets billions, of people making personal decisions that express their preferences. Profits are a natural result of these individual decisions. Provided they are earned ethically and in competitive markets, they should be celebrated, not attacked by those with a prejudice founded on economic illiteracy.*

*First published in *The Otago Daily Times* on 16 January 2004.

Sage words

For my first column of the New Year, I decided I would share with readers some of my favourite quotations. Here goes:

‘The English are not intellectual. They have a horror of abstract thought, they feel no need for any philosophy or systematic ‘world view’.’ – George Orwell.

‘That we may avoid distinction and exception, worship the mean, cultivate the mediocre . . . Saint All Black/Saint Monday Raceday . . . Pray for Us.’ – MK Joseph, poet, on tall poppies.

‘Though my heart be left of centre, I have always known that the only economic system that works is a market economy, in which everything belongs to someone – which means that someone is responsible for everything. . . This is the only natural economy, the only kind that makes sense, the only one that can lead to prosperity, because it is the only one that reflects the nature of life itself.’ – Vaclav Havel, former president of the Czech Republic.

‘It will take six months to reform the political systems, six years to change the economic systems, and sixty years to effect a revolution in the peoples’ hearts and minds.’ – Ralf Dahrendorf, professor, after the fall of the Berlin Wall.

> Our England is a garden, and such gardens are not made
> By singing: “Oh, how beautiful,” and sitting in the shade
> While better men than we go out and start their working lives
> At grubbing weeds from gravel-paths with broken dinner-knives.
> – Rudyard Kipling.

‘The world won’t care about your self esteem. The world will expect you to accomplish something *before* you feel good about yourself.’ – Bill Gates in a speech to high school students.

‘Everybody has asked the question . . . “What shall we do with the Negro?” I have had but one answer from the beginning. Do nothing with us! Your doing with us has already played the mischief with us. . . And if the Negro cannot stand on his own legs, let him fall also. All I ask is, give him a chance to stand on his own legs! Let him alone!’ – Frederick Douglass, leader of the abolitionist movement and advisor to Abraham Lincoln.

‘If men were angels, no government would be necessary. If angels were to govern men, neither external not internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: You must first enable the government to control the governed; and in the next place, oblige it to control itself.’ – Federalist no 51.

‘The way to solve traffic congestion is to have the government owning the cars and business owning the roads.’ – Will Rogers, humorist.

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

‘I have never understood why it is “greed” to want to keep the money you have earned but not greed to want to take somebody else’s money.’ – Thomas Sowell.

Marge exclaims, “Grandpa, where did you get all that money?” Grandpa replies in his croaky voice, “The government gave it to me. I didn’t earn it. I don’t need it. But if they miss one payment I’ll raise hell!” – from The Simpsons.

‘In this and like communities, public sentiment is everything. With public sentiment, nothing can fail; without it nothing can succeed. Consequently he who moulds public sentiment, goes deeper than he who enacts statutes or pronounces decisions. He makes statutes and decisions possible or impossible to be executed.’ – Abraham Lincoln.

‘In Germany they came first for the Communists, and I didn’t speak up because I wasn’t a Communist. Then they came for the Jews, and I didn’t speak up because I wasn’t a Jew. Then they came for the trade unionists, and I didn’t speak up because I wasn’t a trade unionist. Then they came for the Catholics, and I didn’t speak up because I was a Protestant. Then they came for me, and by that time no one was left to speak up.’ – Martin Niemoeller, German Lutheran Pastor.

‘The worst crime against working people is a company which fails to operate at a profit.’ – Samuel Gompers, union leader.

‘If only I knew how to start some kind of business! My dear friend, all theory is dismal and only business flourishes. Unfortunately, I have learnt this too late.’ – Karl Marx.

‘Today we have our payoff. We live in a beautiful home and I drive a new Cadillac. I have literally everything I want. My husband buys me enormous gifts. People say we are rich. I would burn my house to the ground if I could go back to that day at the day care when I pulled away from clinging hands and cried all the way to work.’ – letter from a working mother whose children are now grown.

I hope you enjoyed (at least some of) them.*

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*First published in *The Otago Daily Times* on 2 January 2004.

Part V

2003

OECD gives New Zealand a D grade

The Organisation for Economic Cooperation and Development (OECD) was, in its own words, set up "to achieve the highest sustainable economic growth and employment and a rising standard of living in member countries," while contributing to world trade and development generally.

To that end, one of the committees of its membership, comprising the governments of 30 countries in the higher income category, regularly surveys the economic situation and policies of member countries and offers 'good practice' policy advice.

It is important to understand that the surveys are the responsibility of the member governments, not the Paris-based secretariat which does the preparatory work. Virtually by definition, they therefore reflect mainstream economic thinking acceptable to the 'social market' countries of Europe as well as the Anglo-American world and Japan. The reports are diplomatic and restrained, not radical or leading-edge.

The latest OECD survey of New Zealand, released this month, reveals an interesting contrast between representative advanced country views and those of our government.

Prime minister Helen Clark has said the economy "marked time" in the 1990s. The OECD says that "New Zealand has been one of the fastest growing economies within the OECD during the past decade" – in fact the 7th fastest.

The OECD says that "Underpinning this improved performance has been the programme of reforms that began almost 20 years ago." The prime minister has described them as "failed policies."

The OECD praises the government for having kept in place most of these so-called "failed policies," which it says have delivered low inflation, fiscal surpluses, a flexible labour market and good public sector management, as well as faster growth in employment, productivity and output.

But it says the government has been going largely in the wrong directions – towards more 'hands-on' intervention in industry, favouring particular sectors, renationalising enterprises, re-regulating the labour market, introducing an extra week's holiday which "is not consistent with the government's goal of raising per capita incomes," increasing taxes and making welfare benefit rules more lenient.

Instead of 'activist' government, the OECD advocates strengthening economic 'fundamentals' – less government spending, lower taxes and tariffs, a resumed privatisation programme, better policies for infrastructure (including reforms to the Resource Management Act), less regulation of business, more respect for property rights and stronger work incentives in the welfare system.

The OECD's criticisms and advice are very much in line with those of New Zealand business organisations.

Like them, it points out that while the slide in New Zealand's relative living standards has been arrested, an acceleration of growth to move back into the top half of the OECD rankings is "not in sight." Last week's Budget Policy Statement confirms this assessment.

So, translating the OECD-speak, what does New Zealand's report card look like? For past economic policies and performance, it looks like a creditable B. For the current directions and outlook, more like a failing D grade.

Most media have not given the OECD report the attention it deserves. It is a loud wake-up call to New Zealand.*

*First published in *The Dominion Post* on 22 December 2003.

Running out of oil – again

New Zealand is fast running out of oil, Green Party co-leader Jeanette Fitzsimons MP told an energy workshop in Masterton last month. She was referring to both domestic production and imports.

"Government planners are blithely ignoring the fact that the world's oil demand will very soon exceed supply," Ms Fitzsimons said. She called on analysts and planners to acknowledge that "there is just not enough oil left at an affordable price to fuel New Zealand's future."

We have long been told that we were running out of oil. In 1914 the US Bureau of Mines estimated that there would be oil left over for only ten years' consumption. In 1939 (and again in 1951) the Department of the Interior projected that oil would last only 13 more years.

Danish environmentalist Bjorn Lomborg, who came to New Zealand as a guest of the Business Roundtable earlier this year, quotes Professor Frank Notestein of Princeton, who said in his later years: "We've been running out of oil ever since I was a boy."

The easiest way to tell if a resource is becoming scarcer is if its price goes up in real terms. But the price of oil is well below its earlier peaks, and oil has not become scarcer.

This seems baffling: despite using more and more oil, the world has more and more left. There are three reasons. First, known resources are not finite, but limited by what companies and countries know can be accessed. They won't go in for costly exploration in advance of their foreseeable needs. Second, technology and efficiency have constantly improved. And third, it is possible to substitute. In around 1600, wood became increasingly expensive, and this prompted a gradual switch to coal. During the latter part of the nineteenth century, a similar substitution took place from coal to oil.

In 1865, a highly regarded English economist named Stanley Jevons wrote a book about coal use. He foresaw a relentless increase in the demand for coal, which would inevitably exhaust the nation's coal supplies. He warned: "it will appear that there is no reasonable prospect of any release from future want of the main agent of industry." Jevons' arguments are not dissimilar to those made by Fitzsimons today.

As with oil and gas, coal reserves have increased with time. Worldwide, since 1975, total coal reserves have grown by 38 percent, but the price of coal in 1999 was close to the previous low of 1969. Despite 100 years of mining, only 1% of New Zealand's economic coal resource has been utilised. New Zealand has more than 10 billion tonnes of coal – the equivalent of 50 original Maui gasfields, and

enough to power New Zealand's economy for more than 1,000 years at present rates of energy demand.

The government's goal of achieving annual economic growth of 4% or greater means the economy would be nearly 50% larger in ten years' time. To support that growth, electricity supply needs to expand by a third to a half. Coal is currently used to produce just 5% of the nation's electricity, compared to 80% in Australia and 37% worldwide. This relatively cheap energy offers a strategic economic advantage. Coal technology is becoming ever-cleaner. New Zealand has to have a coal future.

It is not clear today what resources will eventually replace New Zealand's current energy sources. But substitution is bound to occur. Fission and fusion energy both provide possible substitutes, along with renewable sources such as sun, wind, water and the earth's internal heat. The immediate potential of renewables is strictly limited, however: in 1998 wind and solar power accounted for just 0.05 percent of world energy production. This low share is simply a consequence of renewables not yet being competitive with fossil fuels. But with the cost of solar energy and wind energy dropping (by 94–98 percent over the last 20 years), each is becoming closer to being profitable.

As Sheik Yamani, Saudi Arabia's former oil minister and a founding architect of OPEC, has pointed out: "the Stone Age came to an end not for a lack of stones, and the oil age will end, but not for a lack of oil." We will stop using oil when other energy technologies provide superior benefits.

Fitzsimons is right to argue that fossil fuels are non-renewable, but she is wrong to assume that technology will remain constant and we will keep on using these resources in the way that we do today. She is also wrong to worry about both an early end to fossil fuels *and* global warming.

Doom merchants have warned about resource depletion since the Club of Rome's discredited report in the 1970s, and these warnings have been debunked many times. As a former academic, Fitzsimons must be aware of the facts, yet she refuses to engage with them.*

*First published in *The Otago Daily Times* on 19 December 2003.

A country is not a company

Something that I have learned from a career in business and economics is that they are very different vocations, requiring different sets of skills.

Not many people have achieved mastery in both. Some understanding of economics helps in running a business, but it is not a core skill set. Similarly, what people learn from running a business doesn't help a great deal in formulating economic policy. Roderick Deane, who has been both chairman of Telecom and the State Services Commission and in the first part of his career was an expert in monetary policy, is a rare example of a person who is highly qualified in both fields.

Business expertise is about the ability to run a firm. This requires, among other things, entrepreneurship, team management, and financial proficiency. In contrast, economic skills cannot be mastered 'at the coal face,' but must be studied and practised over a long period of time.

Running an economy well requires getting the framework right. The economy is far too complex to be centrally planned. Economic management has to focus on creating a sound general environment, not particular strategies.

Even the most diversified company is unified in some way. Corporations are based upon a core section of the market, or a general range of products and services. Good business executives are extremely focused and knowledgeable about one or a few markets. A chief executive has ultimate control, and can direct the resources of the business. It would take a superhuman feat to plan and run an entire economy. The failure of centrally planned economies tells us it cannot be done.

It is true that there are some things in common between the two areas. For example, incentives matter in both a company and an economy. A good businessperson tries to structure incentives in their firm well. For example, pay will be structured to encourage staff to excel and increase productivity. Likewise, a good economic manager will try to get incentives right – but the tools this person has to work with are things like good laws, sound property rights, and an efficient tax system.

A company is not a country. American economist Paul Krugman got it right when he pointed out that "economics and business are not the same subject, and mastery of one does not ensure comprehension, let alone mastery, of the other. A successful business leader is no more likely to be an expert on economics than on military strategy."

The cross-over is at a more limited level – business people may well have skills that are useful in running a military unit or a public hospital, and can advise or help governments with these tasks.

Business people who try to carry over what they have learned in business to running an economy often get it wrong. Consider the Knowledge Wave conferences and the Growth and Innovation Advisory Board, which have contributed little of significance to the national debate.

The reason for this failure is that business skills are hands-on, but hands-on interventionist policies do not work for an economy. Entrepreneurship is all about finding new ideas for profitable investment, and the best entrepreneurs create wealth for themselves, their organisations and the economy. Conversely, governments have an abysmal track record at 'picking winners' and judging which industries will be important to the economy. Policy makers and politicians typically do not have business skills. The 'Think Big' schemes are an obvious example of what happens when politicians attempt to think and act as though they are running businesses.

As Krugman has pointed out, the best economic management almost always consists of setting up a good framework, and then leaving entrepreneurs to get on with the job, as free from regulations and red tape as possible. He says, "this doesn't make sense to businesspeople, whose instinct is, as Ross Perot put it, to 'lift up the hood and get to work on the engine'."

Economics is in places a difficult and technical subject. Business people should recognise their limitations in advising on economic matters. Typically, they do. Instead of pretending to be experts themselves, they support representative organisations with expertise in economics and policy. This is how the business sector tries to make a professional and constructive contribution to national affairs. Today's business organisations mainly seek to help governments and opposition parties to find ways of improving the overall environment for businesses, rather than advocating on behalf of policies that would assist one company over another.

What we should ask is that both the advisers from business, and those receiving the advice, have a proper sense of what business success does and does not teach about economic policy. The views of politicians about business, and those of businesspeople about economics and policy, should be tested against those who are experts in their fields.*

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*First published in *The Otago Daily Times* on 5 December 2003.

Clock ticking on objectives

In the 1990s, critics of New Zealand's economic reforms often talked of failed policies. Outside economically illiterate quarters, such claims are now much rarer and Government ministers have toned down their rhetoric in the light of the economy's ongoing resilience. Facts have overtaken the debate.

The latest OECD in Figures report shows that New Zealand recorded real economic growth of 3.7 percent a year on average between 1992 and 2002. This was the seventh fastest rate of growth in the OECD, only marginally behind Australia which recorded 3.9 percent. This meant that the economy was 44 percent larger by the end of that decade.

It is astounding to consider that Prime Minister Helen Clark told a London School of Economics audience only last year that, "in the 1990s the economy marked time."

Even more importantly, New Zealand achieved growth in real per capita gross domestic product (GDP), a measure of material living standards, of 2.5 percent a year in the same period. In other words, average real incomes were 28 percent higher in 2002 than a decade earlier and the better economic performance underpinned major increases in spending on health and education the so-called social wage.

The latest OECD report shows that New Zealand has moved up one notch in the rankings to 20th, having overtaken Spain. Those who talk about NZ's continuing economic decline – as though the turnaround following the earlier policy reforms never happened – are simply deluding themselves.

The improvement in economic growth owes much to significant improvements in NZ's productivity growth rate. Treasury, Department of Labour and other studies point to a significant jump in average multifactor productivity growth from 1993 on, after a generally sound overall economic framework was put in place.

When account is taken of the major improvements in employment growth, unemployment, inflation, public debt and New Zealand's credit rating, it is clear that the litany about failed policies of the past still emanating from some trade unions and other quarters is nonsense. The true failed policies were those of the pre-1984 period, which included high Government spending, higher tax rates, Government ownership of commercial enterprises and infrastructure, restrictive labour laws, a state monopoly ACC scheme and economically damaging business regulations.

Despite the Government's claim that it wants to move the economy to a higher growth plane (to regain a position in the top half of the OECD), it has been moving back towards failed policies on all these fronts.

The benefits of the 1984–88 and 1991–92 reforms showed up only from 1993 onward. Equally, the costs of recent mistaken policy changes will show in the real economy only over time.

But they are already showing up in economic projections. All medium-term forecasts, including those of the Government itself, show the economy's performance falling away to well below the average 2.5 percent per capita GDP growth of the decade to 2002.

The Institute of Economic Research projects per capita income growth of only 1.4 percent a year for the five years to 2008.

Finance Minister Michael Cullen has put his credibility on the line by saying that it will be apparent by mid-2004 whether the Government is achieving its growth objectives. Time is running out.*

OECD GDP growth

Average annual real % change 1992–2002

1.	Ireland	7.9
2.	Korea	5.6
3.	Luxembourg	4.8
4.	Poland	4.4
5.	Slovak Republic	4
6.	Australia	3.9
7.	New Zealand	3.7
8.	Canada	3.5
9.	Norway	3.3
10.	Finland	3.3
	OECD average	2.8

*First published in *The New Zealand Herald* on 25 November 2003.

Competition shouldn't be incarcerated: the case for privately managed prisons

Prisons are one taxpayer-funded service that each of us hopes never to personally use. However, we do hold certain expectations about the way they operate. We want the corrections service to contribute to reducing reoffending, and to humanely partition offenders from society. As taxpayers, we also expect value for money.

Value can come in different packages, as British prime minister Tony Blair has discovered. His administration has announced that all new prisons will be designed, constructed, managed and financed by the private sector. Prime minister Helen Clark once claimed that you couldn't put a cigarette paper between her government's policies and Blair's. This particular cigarette paper seems to have gone up in smoke.

There are more than 150 private prisons around the world. About 50 percent of Australian prisons are now privately managed, while in the United States private prisons are dominant and their share is growing. In Canada and South Africa, private sector management of prisons has been in place for some time.

Running against this international trend, our own government has introduced legislation to end New Zealand's sole private prison management contract, and make it illegal for the private sector to run prisons. No groundswell of public support preceded the introduction of the legislation.

A private prison management company, Australasian Correctional Management (ACM), has had a contract to run Auckland Central Remand Prison (ACRP) since July 2000. ACM's contract expires in 2005. Under the proposed legislation, the state provider, the Department of Corrections, will become (once again) the monopoly provider of prison services.

Against this background, the New Zealand Business Roundtable commissioned a paper to explore the proposed legislation.

The report, by economist Phil Barry, found that New Zealand's sole privately managed prison was cheaper to run than the state alternative. The cost of keeping an inmate in a high security prison run by the Corrections Department is $72,000 per year. The cost for a minimum security prison is $54,000. The cost for keeping inmates in Auckland's high security privately run prison, the ACRP, is $43,000 per year. Treasury has told the government that the Corrections Department is unlikely to run the prison for a cheaper price.

If the privately managed prison is providing value for money, why end the contract? As Barry reports, there do not appear to be any claims that ACM has done a poor job. ACM's performance has been monitored quarterly by the Department of Corrections. Performance-linked fees are payable if ACM meets

all key performance indicators. ACM has received a performance-linked fee in every quarter since it started.

Government statistics show that 50 percent of prison inmates identify themselves as Maori. Maori groups are particularly supportive of ACM, not because it runs a five star hotel, but because it has changed the prison culture. Te Warena Taua is a kaumatua from Te Kawerau a Maki, and chairs a group representing six iwi in a formal relationship with the management of ACM. He says that, "under the ACRP contract with a private provider, we have seen more progress and innovation in a prison that we have seen in decades from the public prison service." He considers that "the ACM is universally recognised as the most innovative, progressive and successful prison in the country."

New Zealand's track record with prisons is not good. Our imprisonment rate is one of the highest in the world, and 80 percent of inmates released from prison are convicted of another offence within five years.

Because no other explanation fits, it seems that the decision to stop private management of prisons was ideological, and driven by the interests of public sector unions. The government's argument that the state has to run prisons is wrong, as the practice in other countries demonstrates. The state has to administer the justice system, but there are no constitutional or other barriers to outsourcing custodial or prison services.

Corrections minister Paul Swain professes to be business-friendly, yet he is persisting with a policy that reveals yet again the government's anti-private sector instincts and is against the interests of people whom the government claims to care about

Swain appears to be under the mistaken assumption that "public" and "publicly accountable" are the same thing. That is not so. Consider how little public accountability has traditionally emanated from our state-operated prison service.

International studies show that if private prisons are introduced into a regime of strong public accountability and competition in service delivery, they have the potential to improve the performance of the prison system as a whole.

This ideological decision means New Zealand will settle for a second-best prison service, without the accountability and efficiency that we could achieve.*

*First published in *The Otago Daily Times* on 23 November 2003.

Where everybody knows your name

The idea that we can socially engineer a modern society through large government programmes is on the wane around the world. This is partly because of the realisation that liberal democracies are kept running by mutual trust, tolerance and civic engagement – beliefs, habits and virtues that cannot be achieved by legislation or fiat.

Many of these traits are summed up by the term 'social capital' – the study of which was fashionable during the 1990s among political scientists, anthropologists, economists and sociologists.

When members of a tightly-knit rural community informally keep an eye on one another's homes, that's social capital in action. Ditto the RSA phone-tree that kicks in to alert members of the death of a serviceman so they can attend the funeral. Twelve-step recovery programmes for alcoholics and addicts are social capital in action, and so too are e-mail exchanges among members of a cancer support group.

Social capital is best described as the 'resource base' of a civil society. It embodies the plethora of specific benefits that flow from the trust, reciprocity, information, and cooperation associated with social networks.

The instruments of social capital are families, neighbourhoods, churches, clubs and voluntary societies – even bars. The motto in Cheers, "where everybody knows your name," captures one important aspect of social capital.

Benefits accrue from the flow of information within a network. Many jobs are filled using informal means, because the employer or potential employee has communicated their need to friends, relatives and acquaintances.

Collective action also depends upon social networks. Consider how these must have helped during the recent uprising by rural New Zealanders against the government's proposed research levy.

Social networks help translate an "I" mentality into a "we" mentality, fostering broader identities and solidarity. One study of tertiary students showed that children from 'high' social capital families (with many links to communities and social networks to depend upon) are less likely to drop out of university early.

Social capital provides economic returns for nations, too. A lack of social networks will increase the cost of doing business and inhibit economic opportunities. People who do not trust one another will only be able to cooperate under a formal system of rules and regulations. Widespread distrust imposes a kind of tax on all forms of economic activity.

Like other forms of capital, social capital is not divided evenly around the world. At one end of the continuum, we have truly individualistic societies (Russia and inner-city neighbourhoods of the United States are often cited

as examples) where both families and voluntary associations are weak. Here, the strongest organisations are often criminal gangs. But familistic societies frequently have weak social capital, too. This is because, outside the family unit, unrelated people have no basis for trusting one another. Chinese societies based on Confucianism (which elevates family bonds above other social loyalties) are familistic, but the societies of France and parts of Italy are also said to share this characteristic.

Countries where modern capitalism thrives tend to be those where social capital and generalised trust have been built up by past generations. Societies that have rich networks of voluntary associations and strong communities include the United States, Germany and Japan.

Observers in the United States and Australia have noted that replenishing social capital has become harder.

Paradoxically, although governmental engineering to foster social capital will invariably fail, politicians can easily undermine and destroy social capital.

Left-wing governments sometimes replace community-based welfare services with government-provided services for well-meaning reasons. Yet in doing so, they undermine vital social relationships. And further, by often providing money without reciprocal obligations, they create a perverse incentive not to work, and take people out of institutions (such as the workplace) that provide social capital.

Right-wing governments are not immune to the trap of weakening social capital. If a government funds community-based welfare services, there is a danger that attempts to hold them accountable for their use of public money will turn them into outposts of the bureaucracy, endangering their attraction to beneficiaries and volunteers.

Francis Fukuyama, who visited New Zealand as a guest of the Business Roundtable last year, argues in his book *Trust: The Social Virtues and the Creation of Prosperity* that "social capital is like a ratchet that is more easily turned in one direction than another; it can be dissipated by the actions of government much more readily than those governments can build it up again."

Policy makers need to be conscious of policies with side effects on social capital. The closure of a local school can diminish the sense of community that develops around such schools. Obstacles to job creation reduce opportunities to develop personal skills and to access employment networks. Volunteer fire fighting services can easily be 'crowded out' by their public sector counterparts.

The death of 'social engineering' projects can only be seen in a positive light. But the new challenge – that of allowing social capital to revive – remains an enormous one for modern societies.*

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*First published in *The Otago Daily Times* on 12 September 2003.

Why is Australia doing so well?

Two years ago, many speakers at a foreign policy conference in Dunedin argued that Australia and New Zealand were growing apart. Since then we have seen further divergences over foreign policy, the Kyoto Protocol on global warming, and economic policy.

Average incomes in Australia are already some 30 percent higher than in New Zealand. There is a risk that the gap will widen.

Over a century ago, both countries had open economies, governments that were small by today's standards, and wealth based on the development of resource and land-based industries.

The similarities continued through the early 1900s, when both nations became more inward-looking. Tariffs were imposed, followed by import quotas. Labour markets were regulated and centralised wage-fixing was introduced. State ownership of industries broadened – the Australian government even owned fish and chip shops – and the welfare system expanded.

By the middle of the century, the terms 'fortress Australia' and 'fortress New Zealand' were being used widely. Both countries slipped down the international league tables. We suffered more than our neighbour because bad policies had been taken further on this side of the Tasman, and Australian governments made earlier efforts to reverse the slide.

Change came to both countries in the mid-1980s, with the Hawke government in Australia, and the Lange-Douglas administration here. The programmes of fiscal and monetary stabilisation and structural reform were very similar.

A key difference was that after Paul Keating and then John Howard took over from Bob Hawke, Australian governments largely continued the reforms. Australia has enjoyed the benefits that can only come from a long period of a relatively consistent, coherent and credible growth strategy. In comparison, New Zealand benefited from just two sporadic bursts of reform, under Lange-Douglas and Bolger-Richardson. Both periods were cut short by the prime minister of the day.

Productivity improvements in both countries significantly improved their economic growth rates. But Australia has had the edge: whereas New Zealand has stabilised its fall in the international rankings of per capita incomes, Australia has climbed back into the top half of the OECD.

Gary Banks, chairman of Australia's federal Productivity Commission, said recently that the "main cause of our improved economic performance over the past decade has been (rational) economic reform." He pointed out that if the productivity brought by those reforms had not taken place, "Australian households would have been around AU$7000 worse off on average by now."

Mr Banks likened the reforms to “removing the lead from our saddlebags.” Compare that to the misleading sloganeering by some local politicians and commentators about the “failed policies of the 1980s and 1990s.”

Before the reforms, unwitting governments in both Australia and New Zealand systematically undermined their economies’ productive potential by distorting price signals and protecting producers from competition. As Mr Banks noted, it should not be surprising that the reversal of these policies “has yielded the benefits that economic theory would anticipate.”

Australia’s productivity surge was not produced on the backs of workers through increased ‘work intensity.’ “Increased productivity – through working ‘smarter’ – is the friend, not the enemy, of the work/life tradeoff,” Mr Banks observed.

The OECD recently said Australia’s “commitment to reform … is something that other countries could learn from.” What lessons could New Zealand draw?

Total government spending – the overall tax burden – is considerably lower in Australia than New Zealand as a proportion of the economy. We cannot achieve sustained four percent plus growth rates (as advocated by most of our political parties) without removing some fiscal lead from our own saddlebags.

Australia has been one of the world’s most active privatisers in recent years, whereas – uniquely in the OECD – New Zealand has halted privatisation and moved in the opposite direction. Similarly, our neighbour is well ahead of us in operating infrastructure industries like roading and water on a commercial basis.

Australia relies on private funding in provision of health and education to a greater extent than New Zealand, and its welfare arrangements are generally tighter and relatively less costly than those here.

Australia is by no means perfect. It badly needs more labour market reform to lower its unemployment rate. Its high marginal tax rate is absurd. However, New Zealand must not just strive to match Australia, but needs superior policies to offset our disadvantages of size and location.

Prime minister John Howard – and for that matter many Labor state premiers – keep telling Australians that reform must continue to keep pace with the rest of the world and ensure all Australians benefit.

A typical Australian comment is that you “need only look across the Tasman to New Zealand to see what happens when you open up an economy, and then retreat.”

New Zealand needs Australia’s consensus about the lessons of economic success, and its ambition to do better, if – to borrow our prime minister’s phrase – we are to “close the gaps” in living standards between us and our trans-Tasman neighbours.*

*First published in *The Otago Daily Times* on 24 August 2003.

Restoring philanthropy in New Zealand

When a man or woman is inspired enough, angry enough, or determined enough to alter something in their world, philanthropy can be the result.

Personal freedom is essential to this cornerstone of social change: Philanthropy and voluntarism are associated with liberal societies and not socialistic ones. Liberal government policies – a smaller welfare state and greater personal responsibility – do not make a society more 'individualistic' and 'selfish.' If government is too big and taxation or regulation is too high, citizens will lose both the desire and the capacity to participate in a civil society.

It is not a coincidence that philanthropy thrives in the United States yet wanes in our corner of the world. The American founders recognised that government must be chained for freedom and voluntarism to prosper. Thomas Jefferson warned, "The natural progress of things is for liberty to yield and government to gain ground."

Looking at America today we can recognise that the injunction has not always been followed, yet personal freedom remains a strong underlying theme of American political life, and philanthropy flourishes. So does religion, in contrast to the godless Soviet Union. A spirit of voluntarism also exists – especially among American students in colleges and universities – that would be considered fusty in our own country.

In New Zealand's earlier history, voluntary organisations, mutual societies, churches and charities played a much greater role than they do today.

The story of one mutual society, the Ancient Order of Foresters, is typical. This society began in Britain in 1834. Members felt they had a duty to assist their fellow men who fell into need "as they walked through the forests of life." Members paid a few pence a week into a common fund from which sick pay and funeral grants could be drawn.

The order's first New Zealand chapter was set up in Canterbury in 1852. At its height in 1933, the order had more than 5,000 members in this country.

In Britain, thanks mainly to friendly societies, between 1849 and 1892 the number of 'aged poor' in Britain dropped from over one million to under 750,000. In this time, the overall population rose. As a British government study stated in 1894, "the tendency to join fraternal organisations for the purpose of obtaining care and relief in the event of sickness and insurance for the family in case of death is well-nigh universal." Friendly societies were generally opposed to the concept of state welfare – their opposition to a state pension scheme scuttled the idea in the Australian state of Victoria in 1876.

The aims and objects of Ancient Order of Foresters – providing assistance to the sick and distressed – became less relevant in New Zealand after the advent

of social security in 1938, when the principle of self-help was replaced by a state safety net. Today, local numbers are dwindling. Members are literally dying off, and the order fundamentally exists in Otago for social reasons.

Organisations like friendly societies which argued for personal responsibility and mutual benevolence no longer have the authority to speak for the working poor as they could a century ago. Today, the groups that claim this right most loudly support higher taxes and larger government – policies that will result in an even weaker civil society. They resist proposals to move in the direction of US welfare reforms, despite their spectacular success.

The organisations in the voluntary sector that argue for greater government involvement in education, health and welfare are often said to have become part of a 'welfare industry.' The perverse result is that they oppose the very changes that would lead to more philanthropy.

We need more voluntary organisations to join the call for lower taxation. Lower taxation would not only help the economy, it would also expand the scope for personal and family responsibility and boost charitable giving – as happened in the United States after the Reagan tax cuts of the 1980s.

Charitable giving is an individual responsibility. Businesses can engage in sponsorship activities that benefit their shareholders but in the case of purely charitable activities it is shareholders themselves who should make decisions. In the United States, corporate giving is only about five percent of charitable giving.

And philanthropy is not just for the wealthy. Many Americans in all income brackets regard it as normal to give a week's income or more a year to deserving causes.

The lessons from our own past and elsewhere suggest the state should progressively draw back and allow better-off people to take greater responsibility for their own needs, allow voluntary organisations to provide personalised care for people that government bureaucracies cannot do a good job of helping, and focus on providing an effective backstop safety net.*

*First published in *The Otago Daily Times* on 14 August 2003.

Globalisation is good for the poor

Opponents of globalisation get a lot of air time despite their lack of a coherent alternative. Some, like George Monbiot, who writes for the British newspaper *The Guardian*, have convinced themselves of an elaborate plot in which the rich fiendishly impose a system of world order that keeps the rest of the world poor. Others still labour under the Marxist fallacy that as capitalism grows in strength, poverty and inequality will rise.

These claims are far-fetched and incorrect. But they need to be countered because otherwise fantasy claims about the 'evils of globalisation,' the 'errors of neo-liberal policies' and the 'depredations of big business' get so much attention that they have turn into folklore.

The highly respected British writer Bill Emmott took up this challenge in a lecture to the Institute of Economic Affairs in London last month.

Emmott has the credentials to put forward a solid case. The editor of *The Economist*, he is also the author of three books on Japan – in 1989 he predicted that country's economic ascent would falter. Recently he has focused on the lessons we can take from the 20th century to project what forces will shape the 21st – the resulting book, *20:21 Vision*, has just been published.

In his speech to the IEA, he explored how supporters of free and open markets might respond to the "many different groups and pressures, with wholly different and even incompatible aims that may nevertheless overlap with one another in such a way as to bring about a retreat from liberalism."

The propaganda of protectionists, extreme environmentalists, the self-proclaimed 'global justice' movement, and the many other groups aligned against the free enterprise system would have us believe that globalisation has failed the poor. Yet this is simply not true.

"Far from rising, global inequality has actually been falling substantially," Emmott says. He cites research showing the proportion of the world's population in poverty dropped from 56 percent in 1980 to 23 percent in 2000. Because of population growth, the absolute number of people in that category remains large: more than 1.1 billion today. But that is still fewer than in 1990 (1.7 billion) and 1980 (1.9 billion). "Before 1980, the absolute numbers were rising. That date roughly coincides with the spread of trade and internal-market liberalisation to many poor countries."

More broadly, liberty "has had a fantastic period of advance on all fronts," Emmott argues. Since 1980, 81 countries have taken "significant" steps towards democracy, with 33 military regimes replaced by civilian governments. Of the world's nearly 200 countries, 140 hold multi-party elections.

Looking at capitalism's recent "scandals" in the United States, Emmott notes that the gap between the pay of ordinary workers and top executives in that country widened in the 1990s from around 20 or 30 to one, to 100s or even 1000s to one. In New Zealand, with few exceptions, the range has stayed within earlier US norms. Trends in the US and Britain, he warns, risk "discrediting capitalism in the eyes of the electorate as well as the workforce," and hand "a ready-made and convincing argument to the critics of both capitalism and of globalisation: the idea that it is all a scam, all a matter of greedy plunder."

Emmott is hopeful that the campaign for free trade in food and other agricultural produce – which would naturally benefit New Zealand – will continue with greater success. Farm protection in Europe, the US and Japan costs citizens of those countries hundreds of billions of dollars every year. Emmott says supporters of greater economic freedom could form a tactical alliance with the loose coalition of non-governmental organisations that is opposed to globalisation and capitalism yet has come to argue for liberalisation "through gritted teeth" because farm protection in the West holds back economic development in Africa, Latin America and elsewhere. He quotes James Wilson, the founder of *The Economist*, who wrote in 1843: "We hope to see the day when it will be as difficult to understand how an act of parliament could have been made to restrict the food and employment of the people, as it is now to conceive how ... poor, old, wretched women with a little eccentricity were burned by our forefathers for witchcraft."

Emmott's defence of an open world economy and the role of business exercised in an honest and responsible way is refreshing. He argues that we should look forward to the future with "paranoid optimism." Giving cause for more confidence were the results of a Pew Research Centre poll last month, which asked people in poor countries their view of capitalism and globalisation. Overwhelmingly, they wanted more of both. No doubt, reflecting these opinions, "developing countries still seem to want to liberalise their economies," Emmott concluded.*

*First published in *The Otago Daily Times* on 15 July 2003.

Economic freedom gains ground – but not in New Zealand

An annual event that is useful in benchmarking New Zealand against other countries is the publication of the *Economic Freedom of the World Report*.

The report is coordinated by the Fraser Institute in Canada along with the Economic Freedom Network, a grouping of institutes in 59 countries which includes the New Zealand Business Roundtable.

Economic freedom is of interest because of its relationship to per capita incomes and economic growth. The accompanying chart shows that the group of countries with the freest economies had average per capita incomes of US$23,000 in 2001 (the most recent year for which comparable data are available). The group comprising the least free economies had average per capita incomes of just over US$3,000.

The key ingredients of economic freedom are personal choice, voluntary exchange, freedom to compete and the protection of individuals and property. Using 38 variables for each country, an index is constructed which measures the degree of economic freedom in five major areas:

- size of government: expenditures, taxes and state-owned enterprises
- legal structure and security of property rights
- access to sound money
- freedom to exchange with foreigners
- regulation of capital and labour markets and business operations.

The research indicates that economic freedom worldwide increased further in 2001, continuing the economic liberalisation trend of the past 20 years.

Hong Kong retains the highest rating for economic freedom, followed by Singapore, the United States, and New Zealand and the United Kingdom (both in fourth position). The other top 10 countries are Canada, Switzerland, Ireland, Australia and the Netherlands. Most of the lowest ranking countries are African, Latin American or former communist states.

The research also finds that increased economic freedom does not lead to greater income inequality. More importantly, the actual income of poor people increases as countries gain economic freedom: the average per capita income of the poorest 10% of people in nations in the bottom quintile is US$873 compared with US$6,681 for those in the top quintile.

New Zealand's overall score of 8.2 out of 10 is well above its score of 6.0 in 1985 but down from the level of 8.6 that it reached in 1995. It has a relatively

low ranking (37th) for the size of government and for labour market regulation (21). The latter ranking is only just above Australia's and well below Hong Kong and the United States which rank in second and third place respectively.

We have also lost ground on measures of regulatory impediments to business, and this trend will have continued since 2001.

There are difficulties in measuring economic freedom, and it is not the only determinant of growth. Steady and consistent policies are also important and New Zealand's progress has been marked by instability and some reversals.

This report is a salutary reminder that recent policy directions in New Zealand have been at variance with those of most other countries. Moves in the direction of less economic freedom are likely to lead to a deterioration rather than an improvement in our economic growth rate in the medium term.*

*First published in *The Dominion Post* on 14 July 2003.

Productivity rises fatten pay packets

Over the past decade there has been much debate about New Zealand's productivity performance.

The impact on productivity growth of the economic reforms of the late 1980s and early 1990s is only one measure of their benefits. Others include much lower inflation rates, public debt and unemployment, fiscal surpluses and higher rates of job creation.

There has been a tendency to acknowledge some of these benefits but to question whether policy reform improved New Zealand's productivity performance. Economists such as Brian Philpott, Brian Easton and Tim Hazledine were among the sceptics, and the productivity issue was central to politicians' claims of "failed policies."

The debate is important because productivity is the most important source of sustained growth in a country's average per capita income.

But productivity is notoriously difficult to measure. There are several concepts and each can be measured in different ways. Productivity measurement in the Government and services sectors is particularly problematical – data are subject to revisions that sometimes go back many years, economic cycles need to be taken into account, and changes in trends may not be apparent for many years.

Nevertheless, by the second half of the 1990s the judgments of the sceptics should have been more cautious. There was abundant evidence that firms were using labour, plant, machinery and buildings more efficiently, helped by the Employment Contracts Act.

The average annual rate of real economic growth of 4 percent in the five years to 1996 suggested more than a cyclical rebound.

More importantly, a 1996 study by Professor Viv Hall, of Victoria University, reported a pattern of productivity trends that has been generally confirmed in subsequent work.

Hall's study showed a major improvement in capital productivity and total factor productivity from 1992, compared with the period since 1979, but only a slight increase in labour productivity.

Total, or multifactor, productivity measures are the most important as they show changes in the efficiency with which the economy uses all economic resources. In the mid-1990s, when the economy was absorbing large numbers of unemployed workers, it would have been unrealistic to expect big gains in labour productivity.

(In the late 1980s, labour productivity growth was strong, but largely because of job shedding due to restructuring and a relatively rigid labour market.)

Until recently, the benchmark productivity study was the 1999 report by Denis Lawrence and Erwin Diewert. "After 1993 there was a productivity surge," it found. "This is likely to have been aided by the effects of the labour market reforms of the early 1990s."

NZ's productivity performance after 1993 also seemed to be "at least comparable" with Australia's.

Two recent studies have updated these findings.

A Treasury study by Melleny Black, Melody Guy and Nathan McLellan finds a noticeable improvement in average annual multifactor productivity growth from 0.09 percent in the period 1988 to 1993 to 1.32 percent in 1993 to last year.

It also finds that multifactor growth post-1993 has been similar in aggregate and across industries for Australia and New Zealand. Labour productivity growth rates differ between the two countries because of the different evolution of capital-labour ratios.

Similarly, a Labour Department study by Weshah Razzak finds that productivity growth based on the trend growth rate of real gross domestic product (GDP) per working-age population was 1.99 percent from 1993–2001, well over twice the annual rate of 0.74 percent in 1970–1992.

As an Australian Productivity Commission researcher noted recently, "An acceleration in trend productivity growth of 1 percentage point or so is extraordinary. It is well in advance of the performance in nearly all other OECD economies."

An extra percentage point in productivity growth adds the same increase to the average incomes of New Zealanders. In the last decade, New Zealand's real per capita GDP grew 2.5 percent a year on average, a significantly higher rate than was achieved in the 1970s and 1980s.

Having regard to higher Government spending on services such as health and education in that period, it is not credible to suggest that the vast majority of New Zealanders did not benefit from this improvement.

Razzak's study concludes: "New Zealand needs more capitalism, not less. . . Fiscal policy should not scare capital and labour away from New Zealand by over-taxing them."

To achieve the Government's goal of restoring our average income level to the top half of the OECD, NZ's productivity growth rate needs to rise further. To date there is no sign of this in official projections.*

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*First published in *The New Zealand Herald* on 4 July 2003.

Do we want bureaucrats or entrepreneurs running business?

Question: Would you invest in this company?

Its chairman is also its chief executive, and is 72 years old.

On its seven-member board is his wife, 70; son, 48; vice-chairman, 79, the CEO of a major subsidiary; and two other executives with business ties to the company.

The company doesn't even come close to conforming with the prescriptive rules for corporate governance being canvassed in New Zealand.

Yet Berkshire Hathaway is America's most admired investment company and its founder, Warren Buffett, has created untold wealth for its shareholders.

By contrast Enron and WorldCom had all the standard US corporate governance policies in place.

Similarly, in the last 10 years the four companies that destroyed most shareholder value in New Zealand – Fletcher Challenge, BIL, Carter Holt Harvey and Air New Zealand – satisfied all or most of the prescriptive rules for board and audit committee composition being contemplated.

In a separate exercise the Institute of Directors is proposing that new directors of New Zealand companies will have to take an approved course and be accredited.

The upshot is that someone without formal qualifications could be a prime minister and run the operations of government, but would be debarred from serving as a director of a small public company.

We are at serious risk of losing the plot.

As Graeme Samuel, acting chairman of the Australian Competition and Consumer Commission, has pointed out, the reason for this fixation on prescriptive rules is clear. They suit bureaucrats and regulators because they are visible, compliance is easily measured, and non-compliance is easily penalised.

But an obsession with structure and a belief in the proposition that 'one-size-fits-all' does nothing to prevent fraud and deceptive conduct, or to focus boards on their prime duty of creating shareholder value.

It is one thing to draw up guidelines or codes of general good practice which companies can consider adopting voluntarily. Most New Zealand companies, for example, have already chosen to separate the chairman and CEO roles and to have audit committees.

But it is quite another to insist that conventional practice, which is constantly evolving, should apply in all cases.

Such a dogmatic stance fails to recognise the idiosyncratic nature of business, adds to compliance costs for small companies in particular, discourages public

listings, and risks giving investors a false impression that conformance with rules is an assurance of good governance.

No evidence has been presented that New Zealand's existing rules on corporate governance are inadequate or that prescriptive rules produce superior performance.

In the rush to regulate, shareholders are being overlooked or patronised.

It should be for shareholders, not regulators, to determine which directors will best represent their interests and the nature of their company constitutions, just as it is for voters to choose whom to elect to parliament and the shape of our democratic constitution.

Faced with a choice between Warren Buffett and the raft of companies that have conformed with rules but trashed their shareholders, I know where I would rather have had my money.*

*First published in *The Dominion Post* on 16 June 2003.

Groaning under a heavy burden

For several years the Business Roundtable has been publicising Tax Freedom Day. This year we calculated that it fell between April 23 and May 17, depending on the measure used.

Our preferred measure of the true tax burden is the ratio of government spending to gross domestic product (GDP). This is in line with the practice adopted by organisations such as the Americans for Tax Reform Foundation. They refer to the day when the average person stops working for the Government and starts working for themselves as the Cost of Government Day.

Working from tax figures rather than government spending figures can give a slightly misleading impression of the cost of government.

This can be easily seen in a New Zealand context by considering the Muldoon period. In the 1970s and early 1980s, governments ran large budget deficits because they did not tax as much as they spent. But the result was growing public debt which had to be repaid by later governments running budget surpluses and selling Crown assets.

So taxation in the Muldoon era understated the true cost of government. Government borrowing is simply deferred taxation, since Governments cannot keep increasing debt indefinitely.

Similarly, when Governments tax more than they spend and run surpluses – as is the case in New Zealand at present – the cost of government is overstated. Governments don't run surpluses for ever (even if they adopt tax-smoothing schemes such as the Cullen superannuation fund).

There are also other differences between tax-based and spending-based measures of the cost of government. For example, some government spending is financed by user charges, some of which are equivalent to a tax.

Hence, economists such as Nobel laureate Milton Friedman have advocated government spending as a more accurate and stable measure of the cost of government and the underlying tax burden.

On this basis, Tax Freedom Day in New Zealand fell on April 23 if central government core expenditure, which currently accounts for around 31 percent of GDP measured on the Generally Accepted Accounting Practice basis, is used.

It fell on May 17 if total government spending, including central and local government, is taken into account. This calculation is based on OECD comparisons which allow for variations in government structures. The OECD estimates general government spending in New Zealand is more than 37 percent of GDP.

The merit of calculations of Tax Freedom Day based either on total spending or total tax revenue is that they abstract from the tax structures of different

countries, such as the nature of their income-tax scales and the balance between direct and indirect taxation.

Thus on either a spending or taxation-based calculation New Zealand is a more highly taxed country than Australia or Ireland, even though their top income tax rates are higher.

Why does Tax Freedom Day matter?

First, as the Americans for Tax Reform Foundation explains, a lower cost of government means that more of the money produced by workers, investors and entrepreneurs is left in their hands. That expands personal choice.

Second, a lower cost of government increases incentives for work, savings, investment and entrepreneurship. Hence the reward for these activities increases, and the end result is expanded economic growth and opportunity, with more jobs and higher personal incomes.

Third, many government programmes waste resources.

The evidence is clear that, beyond a certain point, high levels of government spending and taxation harm economic growth and worsen social outcomes.

OECD countries with smaller government such as the United States, Australia, South Korea and Ireland are outperforming the high-tax states of Europe.

A recent study by a leading economist found that tax largely accounts for the 30 percent output (and hence income) gap between the United States and France.

No OECD country has achieved per capita growth rates of 4 percent or more a year on a sustained basis with total government spending and taxation at New Zealand's level.

It follows that this ratio must be reduced if New Zealand is to achieve the Government's goal of getting back into the top half of the OECD income rankings within any meaningful timeframe.

As the *Australian Financial Review* commented in an editorial on this month's Budget, New Zealand's tax burden is too high and New Zealand must regain a taste for reform if it is to match the faster pace of growth in Australia and other Asia-Pacific countries.*

*First published in *The New Zealand Herald* on 27 May 2003.

New Zealand Budget lacks a focus on growth

The background to yesterday's budget is an economy that has averaged real economic growth of around 4 percent annually for the last four calendar years. Unemployment has fallen to around 5 percent of the labour force and capacity utilisation has been high.

The platform for this reasonably robust performance was the economic reforms implemented in the 1980s and early 1990s. In addition, the economy has benefited from a low exchange rate, favourable growing conditions, relatively buoyant commodity prices and a turnaround in net migration.

As a result, finance minister Michael Cullen was able to deliver a budget in which the government's accounts appear superficially to be in tolerable shape.

Headline features included an operating surplus of NZ$4 billion (3.1 percent of GDP) and a continuing fall in net public debt to 14 percent of GDP. Last year New Zealand regained an AAA credit rating.

The Labour-led government elected in 1999 has increased government spending substantially, particularly in the areas of retirement income, health and education. However, it has favoured more centralised control over health and education services, and it is unclear whether higher spending is leading to better outcomes. The greater role of the private sector in Australia appears to be a factor in its superior education performance.

Only the relatively strong economy has kept the ratio of government spending to GDP stable. However, spending by governments at all levels in New Zealand exceeds that in Australia as a share of the economy, and is too high to permit fast economic growth.

The government also increased the top personal tax rate from 33 to 39 percent in 2000. It has rejected the recommendations of an official tax inquiry, the McLeod Review, to move to a lower and flatter income tax structure.

The outlook for the economy is becoming problematical. The budget forecasts are for growth of 2.5 percent in the year to March 2004 and 3.2 percent for the following year.

The long-run projections for the coming decade are for average annual growth of barely 2.5 percent a year. This compares with New Zealand's average annual growth rate of 3.6 percent in the decade to 2002 and expectations of growth rates in the 3–4 percent range in Australia.

The deteriorating outlook reflects the failure of New Zealand governments since the mid-1990s to build on the earlier reforms, an overall lack of consistency and stability in policy, and the present government's more interventionist approach. It talks of "more active" government and dislikes what the budget called "the whims of the market."

Unlike any other OECD government, the New Zealand government has a policy of no further privatisations. It has rejected OECD criticism of renationalising some businesses and engaging in activist industry policies.

The costs of its decisions are now showing up in the government-dominated sectors of the economy such as electricity and transport (particularly roading) which are emerging as bottlenecks to growth, and in growing welfare dependency.

Business organisations have been critical of the government's many anti-growth initiatives. It has responded by affirming that its top priority is to achieve faster growth to restore New Zealand to the top half of the OECD income rankings, a position now occupied again by Australia.

In practice, however, the government has turned its back on the lessons for growth and innovation demonstrated by countries such as the United States. Its bias is towards European-style policies such as union-based bargaining and worker protection laws, heavier regulation of business, a larger welfare state and adherence to the Kyoto Protocol.

Further increases in welfare spending are foreshadowed for the 2004 budget, as well as tax cuts for low income earners which would widen rather than flatten the tax scale. The focus is still on income redistribution, not wealth creation.

New Zealand's overall economic framework remains within OECD norms, and there is no likelihood of major policy reversals. Economic performance is likely to be average by OECD standards.

The problem is that the prospects of further improvements are currently not good, and that the economy will continue to perform below its potential.

Although the economic reform process in Australia can be criticised as patchy and lacking adequate momentum, its direction has been generally consistent and market-oriented. New Zealand, by contrast, has followed an erratic path and it has been headed recently in the direction of less rather than more economic freedom. Business organisations in general have been pointing out that this is not a recipe for economic growth.

With the economy slowing and strains in infrastructure and other areas becoming more apparent, their views may get a better hearing.[*]

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[*]First published in *The Australian Financial Review* on 16 May 2003.

Will we get a Budget of substance?

A budget is about the state of the government's books. It should also be the place where the government draws together its overall economic strategy.

The government has claimed the mantle of prudent fiscal management based on balancing the books with the aid of strong economic growth.

But it has been less prudent in controlling the level of government spending and its quality.

In 2000, it decided to raise central government spending from the level of 30% of GDP, as targeted by the previous government, to 35%. This plan to appropriate a further twentieth of national income to the public sector is perhaps its single most important economic decision.

Big government, and the taxation associated with it, harms growth. No competent economist denies this. Finance minister Michael Cullen sometimes agrees. He told a recent Grey Power audience that significant increases in taxes would slow the economy.

No OECD country has achieved the government's goal of lifting the annual economic growth rate to 4% per capita on a sustained basis with total government spending (central plus local) at New Zealand's level.

Moreover, much of the government's spending is wasteful. The OECD said last year that 95% of it is not properly evaluated.

Lowering the government spending share of the economy does not mean 'slashing' public services. Ireland has reduced its spending ratio from over 50% of GDP to around 30%, and the faster economic growth rate that it helped engender has allowed big increases in health and education spending.

The budget may include tax measures affecting company superannuation schemes and small and medium-sized enterprises. These are helpful but minor. The government has continued to reject the far more important McLeod review's recommendations for a lower and flatter tax scale.

Analysis of the budget should focus on the big picture. Supporting business development does not consist of throwing money at a yacht race or a few more business incubators.

This is trivial pursuit. Lower spending and taxation are better for business at large.

Even if such handouts made sense, they could not possibly make a perceptible difference to the growth rate of a $120 billion economy.

A government committed to growth must focus on serious growth-raising measures. The previous government's partial deregulation of ACC was estimated to produce cost savings of around $300 million. Analysis suggests there would be

around $1 billion of annual benefits from fixing Auckland's transport problems. These are the sort of things that matter for growth.

Business leaders have been saying that escalating government regulation and the failure to address infrastructure crises in electricity and roading are choking off investment and growth.

Evidence for this view is mounting. In the 10 years to 2002 the economy averaged 3.6 percent annual growth. The budget will show that the outlook for the next decade is weaker.

Dr Cullen has stated that by this time next year it will be clear whether the government's growth strategy is improving this outlook. That is unlikely unless the government heeds the calls that business leaders and organisations are making.*

*First published in *The Dominion Post* on 14 May 2003.

Economic reform: the rhetoric and the reality

Ten years ago, a former financial secretary to the UK Treasury, John Moore, said about privatisation in Britain: "Private ownership has won ... the reason that the political contest over privatisation came to an end is simply that implementation succeeded. Facts overtook the debate."

Much the same thing seems to be happening in the debate over New Zealand's economic reforms. Talk of "the failed policies of the past" is now heard less frequently, even in government circles.

The change in the government's rhetoric and attitude is apparent from recent articles in *The Australian* by its economics editor Alan Wood, perhaps Australia's leading economic journalist.

Wood visited New Zealand in March as a guest of the Ministry of Foreign Affairs and Trade in conjunction with the visit of Australian prime minister John Howard to mark the anniversary of the Closer Economic Relations agreement between the two countries.

In one of his articles, Wood wrote that "CER has certainly played a part in NZ's and Australia's current prosperity, but the economic reforms in both countries in the 1980s and early '90s were crucial. They are what delivered NZ's improved economic performance in the '90s, together with some cyclical factors such as good seasons, good commodity prices, high immigration and a low exchange rate."

Wood quoted prime minister Helen Clark as referring to "the stellar performance" of the New Zealand economy and heaping praise on CER, even though she had opposed it in her maiden speech in parliament.

In his speech, John Howard said: "The change and reform that has occurred in both countries – the deregulation of the New Zealand economy was a trailblazer for many other countries – and the strength and the vitality of so much of what you have now is due to reforms carried out in the 1980s and continued by successive governments."

Wood acknowledged that Helen Clark had recently spoken of the "discredited and discarded agendas of the '80s and '90s" but added: "However, some of this is just rhetoric. After a false start in the early months of her government and a heated clash with influential sections of the business community, Clark has not made any radical attempt to turn back reform... Talking to Labour ministers and to the Prime Minister, it is clear that their mind-set has been importantly influenced by the reformers."

Indeed, the reality behind the rhetoric was apparent much earlier. In an interview with a Japanese journalist in 2000, finance minister Michael Cullen stated: "Fundamentally we will not change our open market policies. It is

not necessary. The structural reforms produced great results. Most privatised corporations have been successful. What the current government is doing now is not because the structural reforms were wrong, but because we want to adopt a pragmatic approach to do better."

Facts have overtaken the economic reform debate too. Statistics New Zealand's latest figures for real gross domestic product (GDP) show that for the 10 years to the end of 2002, average growth in real terms was 3.6 percent a year. This means the economy in 2002 was over 40 percent larger than it was 10 years earlier.

This growth rate was better than what the well-performing US economy achieved in that period, better than the G7 countries, but somewhat below Australia which achieved around 4 percent average growth.

Even more importantly, real per capita GDP – reflecting the average income of all New Zealanders – grew by 2.5 percent a year on average in that decade. This means that average incomes were 28 percent higher in 2002 than they were 10 years ago.

Having regard to increased government spending on services such as health and education – the so-called social wage – in that period, it is not credible to suggest that the vast majority of New Zealanders did not benefit from this improvement.

Growth for the 10 years from 1992, when the economy began to expand after the structural reforms of the 1980s and the additional fiscal and labour market measures of the early 1990s, was comparable to the decade of the 1960s and much better than the 1970s and the 1980s.

Productivity improvements were clearly responsible for a significant part of the improved growth performance.

In addition, there were major improvements in inflation, employment, unemployment, the government's fiscal position including public debt, and New Zealand's credit rating.

While there was much about the reforms that was imperfect and incomplete, to refer to them as the 'failed policies of the past' is clearly ludicrous. As Wood noted, the potential problem is not that the government has made radical changes to New Zealand's economic framework but rather its "shift towards microeconomic and welfare policies that over time threaten to undermine the economy's flexibility ... and the associated productivity it yields [that] is vital to NZ's future prosperity."

Wood quoted OECD figures for average Australian per capita income of US$23,492 (NZ$42,713) and New Zealand per capita income of US$17,511 (NZ$31,838) on a purchasing power parity basis, "a big gap [34 percent] and one that will go on growing unless NZ can match or better Australia's growth performance."

If, assuming similar population growth rates (which has been the case in the last 10 years), New Zealand's future average annual growth rate was 2.5 percent and Australia's 3.5 percent, average Australian incomes would be 42 percent higher than New Zealand's in 10 years' time and 60 percent higher in 20 years.

Wood concluded that "another round of bold policy reforms" is needed if a further large decline in relative incomes is to be avoided.

In the face of that prospect, will the government, which has moved, however grudgingly, to accept the logic and merits of the earlier policy changes, be prepared to move further? Clearly its current approach of 'incrementalism' won't do the job and its overall policy direction, which is out of line with that of other OECD countries, is more likely to widen the gap than close it.*

*First published in *The National Business Review* on 25 April 2003.

Protectionism: time to quit the habit

New Zealand has been dismantling barriers to import competition for over 20 years.

Earlier 'fortress New Zealand' policies led to inefficient production of goods like cars and television sets, high prices to consumers, and cost burdens on export industries.

Import licensing as well as high tariffs meant effective tariff rates were sometimes 100% or more.

Today goods subject to tariffs usually face rates of 5–7%, though some face rates of up to 19% – or more where specific duties apply.

New Zealand is thus within sight of full free trade, like countries such as Singapore and Hong Kong which have had no tariffs for years.

The business community at large accepted the previous government's decision to phase out remaining tariffs by 2006 – most by July 2001. The decision by the incoming government in 2000 to freeze this programme was unnecessary.

This year the government must decide what happens after 2005.

The circumstances for removing all tariffs are favourable. Compared with the challenges of adjusting to the removal of import licensing and high tariffs, the adjustments required to complete the process are small.

Unemployment is down to 4.9% of the labour force. At a time when resources are locked up in the protected apparel sector, firms in the unprotected export fashion business are crying out for machinists.

Tariffs on clothes and shoes hit low income consumers hardest. Such tariffs are a tax of up to 19% or more compared with the GST rate of 12.5%.

Getting rid of tariffs would also save taxpayers' money on customs administration, reduce compliance costs to businesses, prevent resources being wasted by firms petitioning governments for assistance, and facilitate free trade agreements such as the stalled negotiations with Hong Kong.

It makes no sense for New Zealand to wait for other countries to make similar moves. A policy to refrain from taxing our own consumers and misallocating resources only if other countries do likewise is inherently silly.

People benefit from giving up their smoking habits even if others don't, and even if they are still harmed by other smokers.

New Zealand benefits from liberalisation moves by other countries, but a small country can reap most of the gains from free trade by simply removing its own trade barriers. Doing so would make it easier, not harder, to negotiate a wider trade agreement with the United States, as the recent conclusion of an agreement by that country with Singapore illustrates.

In multilateral negotiations, what matters is actual tariff rates, not bound rates, so New Zealand loses nothing by unilateral action.

Research indicates that the sum of the gains from removing even low tariffs is significant. Many policies to improve economic growth are politically difficult. Given New Zealand's current circumstances, and its existing APEC commitment to remove all tariffs by 2010, a move to full free trade is relatively easy.

If the government is serious about its goal of restoring New Zealand to the top half of the OECD income ladder, tariffs are low-hanging fruit in a growth strategy.*

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*First published in *The Dominion Post* on 14 April 2003.

Making sense of sustainable development

'Sustainable development' is a term that has been around for about 30 years. Over that time it has been interpreted in a variety of ways, divided broadly between pro-growth and anti-growth approaches.

In the last year or so several developments suggest the more enlightened interpretations are gaining ground.

One was the publication of *The Skeptical Environmentalist* by Bjorn Lomborg, a former Greenpeace member. This book, which has had a huge impact worldwide, exposes the litany of environmental myths and painstakingly documents the evidence that environmental quality has generally been steadily improving – at least in the developed world. Lomborg is visiting New Zealand in October 2003 as a guest of the Business Roundtable and the Resource Management Law Association.

Another milestone was the World Summit on Sustainable Development in Johannesburg, which may mark a turning point in the international environmental debate. The main theme of the Summit was that "poverty is the worst polluter," and that the best environmental policy is economic growth based not on government planning but on markets and private initiative.

Recently, Joseph Healy's book *Corporate Governance and Wealth Creation in New Zealand* reaffirmed the prime duty of company boards and managements to pursue the goal of shareholder wealth creation rather than a nebulous triple bottom line.

No sensible person is against sustainable development. The relevant issue is not the goal but what it means and how best to pursue it.

A common definition of sustainable development is that which "meets the needs of the present without compromising the ability of future generations to meet their own needs." A moment's thought, however, suggests this definition is hopelessly problematical.

A planner in 1900 concerned about the needs of people in 2000 would have worried about supplies of whale oil for lighting, firewood for heating, copper wire for telecommunications, rock salt for refrigeration and horses for transportation. With technologies such as CDs, MS-DOS and the internet not even in existence 20 years ago, how can we possibly know what the needs of people in 2100 are likely to be?

Efforts to pursue intergenerational equity need to take account of the fact that future generations will almost certainly be far, far better off than present generations. How much should relatively poor people today be asked to sacrifice to benefit future generations whose living standards may be equivalent to those of today's mega-wealthy?

Seen in this way, sustainable development – meeting the needs of the present without compromising the future – is a reality here and now. As Cato Institute director of natural resources Jerry Taylor has written:

> Look at the data. Life expectancy across the globe has shot up over the course of the last two centuries. People are better fed, better clothed, and better housed today than ever before... Air and water pollution in the most industrialized nations of the world is a mere shadow of what it was decades ago. Even Third World countries have found that, once per capita income reaches a certain point, economic growth coincides with a cleaner environment... The human footprint on the environment is indeed becoming lighter and softer.

The pessimists have been wrong because they misunderstand the way the world works. Inflation-adjusted prices of natural resources have been falling for centuries. Even petroleum is becoming more abundant, not more scarce: supplies of conventional and unconventional oil could last for a thousand years. Solar power will be available for billions of years.

The greatest resource of all is human ingenuity. When things are genuinely in short supply, prices rise, people conserve more, or switch to substitutes, or find ways of increasing supply – all of which eases the shortages.

The outcome of the Johannesburg Summit suggests that a new agenda for sustainable development may be taking shape. Rather than focusing narrowly on 'sustainability,' it recognised that what developing nations need is economic development from which environmental progress will follow.

Also, there is an increasing consensus about the best means of advancing sustainable growth. A recent World Bank study found that economic policies that led to the greatest amount of ecological sustainability were adopting market-determined interest and exchange rates, reducing government budget deficits, promoting market liberalisation, fostering international openness, enhancing the role of the private sector, and strengthening government and market institutions, coupled with pricing and other reforms in key sectors such as industry, agriculture and energy.

All of these findings are relevant to economic and environmental policies in New Zealand. Both our economy and our environment have benefited from efforts to get prices right, establish clear property rights (eg in fisheries), remove subsidies, open markets to competition, and corporatise and privatise state-owned businesses.

There is ample scope for further advances. Both the economy and the environment would benefit from decisive action on roading to reduce traffic congestion in Auckland. We should get serious about genuine environmental problems rather than over-react to remote ones such as global warming. Problems

such as water quality, erosion, loss of native birds, destruction of native forests by possums, and smog in Christchurch are crying out for attention. The solution to many of them lies in creating clear property rights, developing markets for trading, and introducing commercial structures and incentives.

At a company level, there is also a need for clearer thinking about environmental issues. I know of no New Zealand business leaders who are not environmentally conscious, and who would not see a good environment as part of the overall quality of life. Companies in land-based industries may well see reporting on their environmental practices and standards as making good business sense.

But it is another thing again to advocate that firms should be forced to embrace triple bottom line accounting. There are serious risks that by going down this path, companies will neglect their prime duty to create shareholder value, waste money on consultants and corporate bureaucracies, and create multiple objectives which blur the accountability of boards and management for performance.

Sustainable development and economic growth are quite consistent – indeed growth promotes sustainability. Properly understood, sustainable development is not in conflict with the government's goal of returning New Zealand to the top half of the OECD income rankings.*

*First published in *The New Zealand Herald* on 4 April 2003.

The co-operative company as a business model

Business is conducted through all manner of legal entities. They include private companies, publicly listed companies, partnerships, trusts, co-operatives, mutuals, non-profits and state-owned enterprises. Hybrid forms also exist.

In some industries one type of firm is dominant and it is often easy to see why.

In farming, for example, the typical business model is an owner-managed farm, partly because monitoring of farm management by outside investors can be difficult. Yet some trusts and corporate farming operations have also prospered.

Some organisational forms are less successful. For example, research indicates that, on average and over time, state-owned enterprises perform less well than privately owned firms because governments are driven by political rather than commercial imperatives. These findings have motivated the worldwide privatisation movement. Some SOEs have succeeded, at least for a period of time, but it is unwise for policy makers to bet against the odds using taxpayers' money.

The SOE example illustrates why it is dangerous to argue that ownership and organisational arrangements don't matter, and that all that counts is having good people running the business. Incentive structures and industry characteristics affect the choice of business organisation in systematic ways.

The key to ensuring the good performance of all types of businesses is open competition – for the goods and services they produce, the inputs they use and the organisational forms they take. Actual or potential competition from other forms of business (eg between corporates and co-operatives), and the freedom to change from one form to another, is an essential aspect of competition and a stimulus to good performance. As a rule, statutory protection for any particular form of organisation should be avoided.

Co-operatives and mutuals (which are closely related) co-exist with corporates in many industries, including retailing, financial services and agriculture. Firms like Foodstuffs, Mitre 10 and Plumbing World trade successfully in open competition with corporates and without statutory protection.

Co-operatives can work well when the number of owners is small, the product range is limited, the firm can be easily monitored and capital requirements are not large.

Demutualisation of financial mutuals has been occurring because of the pressure on financial services firms to provide a wider range of products, difficulties of monitoring large mutual organisations and capital requirements.

Internationally, some health insurers, stock exchanges and agricultural co-operatives have also demutualised and brought in outside investment, but there have been a few moves in the opposite direction.

From the perspective of an owner (eg a farmer), demutualisation can have the attraction of not having to be both a supplier and an investor in a co-operative company. Investment risk can be diversified outside the industry and security of supply can be ensured through contracts.

In the dairy industry, an additional problem with co-operatives has been the bundling of returns from milk supplies with returns from off-farm investment, resulting in pricing distortions and over-production. This has been reduced with the 'fair value' entry and exit provisions but accurate valuations will remain difficult in the absence of a liquid market for shares.

In the United States, co-operatives still predominate in the dairy industry, but this may be partly due to the tax and regulatory privileges they enjoy. There is a more diverse mix of co-operatives, listed companies and multinationals (including involvement by Fonterra) in the Australian dairy industry.

The development of value-added products and brands, which are capital intensive and risky, together with expansion offshore and into non-dairy products, is likely to require more outside investment in the New Zealand dairy industry and moves away from the pure co-operative model. This pattern has been seen with the Kerry Group in Ireland and with Wesfarmers (in non-dairy activities) in Australia.

More generally, New Zealand has an unusual number of co-operatives, trusts and state-owned enterprises in its business sector, and a correspondingly smaller public equity market. This point is often overlooked in debates about the New Zealand Stock Exchange. Over time these proportions are likely to change.

There is no case for government action to force owners of businesses to change their organisational form.

The government's job is to ensure that tax laws and commercial regulations are neutral, and to enforce them (eg not exempt merger proposals from Commerce Commission scrutiny).

It is for owners to be alert to the commercial advantages of possible changes, and for boards to put proposals to them for their approval or rejection.*

*First published in *The New Zealand Herald* on 25 March 2003.

Labour's economic drive loses momentum

New Zealand's economy, like Australia's, has been weathering the international downturn tolerably well. Indeed, since the end of the Asian crisis in December 1998, output has expanded by 15 percent in New Zealand, compared with 12 percent in Australia, according to the New Zealand government's December 2002 economic and fiscal update.

Economic growth in New Zealand last year seems likely to have been about 4 percent.

What's more, unemployment fell to 4.9 percent of the labour force in the December quarter, and inflation is within the Reserve Bank's 1 percent to 3 percent target range, albeit at the high end of it.

The government's budget is still showing an operating surplus, which looks solid going forward. Last year, Moody's Investors Service upgraded New Zealand's foreign currency credit rating to Aaa, the same as Australia's.

Taking a longer-term perspective, the New Zealand economy grew by 3.2 percent a year on average in the decade to 2003, according to International Monetary Fund figures. This was much better than Japan (1 percent) and Germany (1.6 percent), but behind Australia's average annual growth of 4 percent.

Like Australia, New Zealand has benefited from market-oriented economic policy reforms. In New Zealand's case, this occurred in two waves: 1984–88 under a Labour government, and 1990–91 under a National government.

Over the past couple of years, the economy has also received a boost from favourable weather conditions, good commodity prices, relatively easy monetary conditions and a low dollar.

Economic activity now appears to be slowing, with New Zealand perhaps three to six months behind Australia's stage in the business cycle. Forecasters are picking growth of around 3 percent or below for the year ahead.

Despite much rhetoric about "the failed policies of the past," the present Labour-led coalition government, which came into office in late 1999 and was re-elected in 2002, has made marginal rather than fundamental changes to the economic framework. This appears to reflect a general public consensus – perhaps grudging in some quarters – that the reforms were necessary and overdue.

But the government has done little to build on the earlier foundations, continuing the apathy of National-led governments after Ruth Richardson was dropped as finance minister in 1993.

As a result, its declared goal of returning New Zealand to the top half of the Organisation for Economic Co-operation and Development's income ladder – a place now occupied again by Australia – lacks credibility.

The key difference between the two countries is perhaps that Australia has been a more consistent reformer, and that its overall economic policy settings are superior to New Zealand's. As a consequence, it looks set to continue outperforming New Zealand. Indeed, there is a risk that New Zealand's performance will weaken over the medium term.

Among recent government policies are an increase in the planned share of government spending in the economy; the rise in the top personal tax rate to 39 percent; partial re-regulation of the labour market and network industries; a freeze on tariff reductions; re-nationalisation of some businesses and a policy of no further privatisations; and ratification of the Kyoto Protocol. These are all bad for growth.

The changes do not immediately threaten New Zealand's generally sound economic framework, but are heading in the wrong direction. They risk weakening, not strengthening, the economy's performance over time.

There is no reason why New Zealand cannot do a lot better: Ireland, a country with a similar population, achieved average economic growth of 8 percent a year in the past decade. Any disadvantages of size and location are relatively minor. It's hard to see why New Zealand is any less well placed than, say, Western Australia in geographical terms.

What seems to count most for economic performance is a country's institutions and policies. The business community is telling the government that, contrary to the situation in the 1980s and 1990s, its general policy direction is at variance with that of Australia and other more successful OECD countries.

To improve its economic performance, the basic requirements for New Zealand are smaller government, lower taxes, less regulation of businesses and the labour market, more restrictive welfare policies and more private sector involvement in health and education.

Many New Zealanders have been worried that the country has been drifting apart from Australia, on economic as well as other issues.

Remedying this drift is not primarily a matter of deepening the Closer Economic Relations agreement. CER has been valuable for both countries, especially New Zealand, as part of the process of opening up our economies to the world.

Making progress on outstanding issues would be helpful, but is not fundamental.

The value of each country to one another as trading, investment and business partners will be much more dependent on the domestic policy decisions that will determine their future performance, as well as on their engagements with major countries like the United States and the international economy at large.*

*First published in *The Australian Financial Review* on 13 March 2003.

Getting back on the Australian radar screen

Almost exactly a decade ago, the Business Council of Australia (like the Business Roundtable, an organisation of CEOs of major firms) published a manifesto *Australia 2010: Creating the Future Australia*.

Among other things it said: "A century ago Australians enjoyed the highest standard of living in the world. In 1970, Australia was 10th . . . we are now 18th.

"There is no feasible alternative to transforming Australia into an outward-looking internationally competitive economy. . . Change must be executed swiftly."

Today Australia is back up to 12th position in the OECD rankings (New Zealand is in 21st place). Australia's economy grew by 4% a year on average in the decade to 2003, outstripping New Zealand's improved growth rate of 3.2% according to International Monetary Fund statistics.

And Australia has not been a stand-out performer. Among advanced economies Ireland, Luxembourg, Korea, Taiwan and Singapore all grew faster in that period – Ireland grew twice as fast.

Yet our government is now saying it is unrealistic for New Zealand to get back into the top half of the OECD within a decade. Why?

On his recent visit to New Zealand accompanying the Australian Treasurer Peter Costello, the secretary to the Australian Treasury Ken Henry was asked why Australia was doing so well.

His answer was "good policies." When asked "what else?," he replied "good policies."

Few in Australia doubt that answer. As an editorial in *The Australian* last month noted, "Many of the best things about our society right now flow from the reform push of the 1980s and 1990s. These benefits have been chronically undersold. They include nearly 2 million jobs created over the past decade, low inflation and interest rates, and a level of economic growth that has enabled us to sail through a succession of global crises."

New Zealand has had similar benefits from its earlier reforms. They too have been woefully undersold by successive governments which have instead squandered the growth 'dividend' with ill-justified spending and regulations.

Ten years ago New Zealand was very much on Australia's radar screen. Its economy was growing faster than Australia's in the mid-1990s. A succession of Australian firms crossed the Tasman to set up operations.

New Zealand was leading Australia in some areas of economic reform. Its successes were closely watched: the Kennett government's reforms in Victoria were modelled on New Zealand's.

Many Australians were taking notice of a country that they had regarded as a chronic under-achiever.

Since that time a market-oriented reform programme stalled and has now been partially reversed in New Zealand, but it has been continued in Australia. Major changes include Australia's adoption of a goods and services tax, large-scale privatisation, further tariff reductions and partial reform of the labour market.

Australian attitudes to New Zealand have also changed.

In an editorial in October 2000, the *Australian Financial Review* wrote: "New Zealand's Prime Minister, Ms Helen Clark, simply could not be more wrong when she slams her nation's senior business leaders for "taking the country down"... Criticism of the Labour Government's "backward looking" economic agenda is a timely warning that the Kiwis are retreating from the reality of the global market-place."

Last year former Liberal Party minister Peter Reith told a New Zealand audience: "There was a time, not so long ago, when New Zealand was at the forefront of economic reform and you had a reputation to match. I am sorry to say that no one today would think to take a lead from New Zealand."

And New South Wales Labor premier Bob Carr was reported as saying that he did not want Australia to replicate New Zealand Labour's performance – a strategy that "has turned back from economic competitiveness."

New Zealand has also drifted apart from Australia on security and foreign relations issues. A case in point is Australia's decision to go it alone in seeking a free trade agreement with the United States.

Getting back on Australia's radar screen is not primarily about extending the Closer Economic Relations agreement.

Outstanding CER issues are relatively minor. There would be modest benefits from things like further mutual recognition agreements and the abolition of passport controls. It would not make sense for New Zealand to adopt the Australian or US dollars without first achieving a more flexible economy with a smaller government role.

In looking to Australia, New Zealand has a habit of wanting to copy the wrong policies.

There is an endless push from New Zealand bureaucrats to adopt features of Australian business law that are widely criticised in Australia. When discussions were taking place about a possible merger of the New Zealand and Australian stock exchanges, leaders of the ASX were hoping that a merger might facilitate changes in Australia's takeovers regime in the direction of the less restrictive model then in place in New Zealand. Subsequently New Zealand has moved towards Australia's regime which gives more protection to under-performing companies and no weight to shareholder choice.

Trade practices legislation that might suit Australia does not necessarily suit New Zealand's smaller economy.

Instead, New Zealand should be looking to adopt those Australian policies that help account for that country's superior economic performance.

Among them are a smaller government sector (spending by all levels of government in Australia is equal to about a third of gross domestic product compared with nearly 40% in New Zealand), more restrictive welfare policies, an income and assets tested retirement safety net, and much great private sector involvement in health, education and infrastructure such as electricity, water and roading.

As Ken Henry's comment indicated, and some New Zealand commentators do not understand, better policies and institutions (like sound laws protecting property rights and contracts) are the key to economic success.

New Zealand business performance improved vastly with the earlier policy changes and could be improved much further.

Contrary to urban myths, many New Zealand firms have shown an ability to foot it in Australia. Lion Nathan, Fonterra, Carter Holt Harvey, The Warehouse, Michael Hill Jewellers and Fletcher Building are just some of them. Entrepreneurs Sir Ron Brierley and Graeme Hart have done well.

To be sure there have been failures but many Australian firms have also done poorly abroad – K Mart in New Zealand, AMP in Britain, NAB and BHP in the United States, WMC in Canada and more. That's business.

Talk of being a branch economy in both Australia and New Zealand is just silly. In an era of globalisation, any economic area can be called a branch economy.

So too is pessimism emanating from some parts of the Treasury about New Zealand's size and location, and views that lower income countries are poorly placed to compete with higher income ones that can attract talented people. The general economic pattern is one of convergence – of countries catching up to the high income leaders.

Australia is still ambitious to do better. Prime minister John Howard constantly reminds Australians of the need for ongoing reform to stay competitive – even if his government's actions don't always match his words.

So too do Australian media. The editorial in *The Australian* quoted earlier argued for extending microeconomic reform, further privatisation, internationally competitive taxation, and less bureaucratic control and more consumer choice in health and education: "the last areas of the economy, apart from the cultural sector still organised for the convenience of producers."

New Zealand's policy reforms arrested its earlier relative decline. But average Australian incomes in 2003 are roughly 30% higher than in New Zealand.

If Australia were to achieve average economic growth of 3.5% a year and New Zealand just 2.5%, that disparity would rise to 42% over 10 years and 60% in 20

years' time. With gaps of that size there would be "a giant sucking sound" as firms and skilled people migrated across the Tasman.

If New Zealand wants to avoid that scenario and get back on Australia's radar screen it needs to take Ken Henry's words to heart.

It's the policies, stupid.*

*First published in *The New Zealand Herald* on 7 March 2003.

Should our land be sold to foreigners?

Foreign investment is a good thing. It can provide additional capital, new management skills and technology, and links with overseas markets.

New Zealand was built with foreign investment. Policies toward foreign investment have always been liberal – even before the liberalisation moves of the last two decades.

By and large the same arguments apply to investment in land.

Foreign investors employ New Zealanders on farms, establish forestry export operations, develop tourist facilities and pay rates and taxes.

People who have worked hard to develop a property want to get the best price for it if they decide to sell – which may be from a foreigner. The best price offered for an asset usually signals the most valuable use.

There are some special features about land. Sales to foreigners of land of special historical and cultural value, foreshores, islands and the like have long been scrutinised. Such scrutiny is reasonable.

Recent changes in rules seemed unnecessary and in practice have probably done little other than to add to the costs of those who have to administer and comply with them.

In particular, the element of politicisation requiring ministerial decisions in some cases was a backward step.

There has been no upward trend in approvals of land sales to foreigners. The best estimate is that about 4% of land is in foreign hands. By comparison, a third is in the public conservation estate.

Calls for greater controls owe more to emotion than logic. A while back New Zealand interests owned John o'Groats and Land's End. Should British people have been outraged?

Economic sovereignty has much more to do with running a sound economy than owning particular assets.

There are no good grounds for tighter controls. Foreign owners of land have sometimes been more sensitive to public interests than New Zealand owners. And in the final analysis, foreigners can't take land away.*

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*First published in *The Sunday Star-Times* on 2 March 2003, alongside an article by Bill Rosenberg of Canterbury University, who argues that there should be restrictions on foreigners owning New Zealand land.

R & D subsidy-seeking habit hard to break

By and large, industries in New Zealand have stopped lobbying for taxpayer subsidies and expect to survive by competing in the marketplace.

One form of subsidy-seeking that has a habit of coming back is for more government spending on research and development (R & D). A recent example was a report *Making R & D a National Priority* by McKinsey & Company for the Knowledge Wave Trust.

Often the case for more spending is based on nothing more sophisticated than the observation that New Zealand's reported R & D spending is low by OECD standards, and that R & D is important for economic growth.

As it happens, the latest OECD figures indicate gross expenditure on R & D in New Zealand is 1.11% of GDP, not far short of the figure of 1.21% for the well-performing Irish economy.

Moreover, government spending on R & D in New Zealand is higher as a proportion of GDP than in Ireland. So too is higher education expenditure on R & D and the number of researchers per 1000 employees.

Lobbyists for R & D subsidies seldom acknowledge the following points:

- R & D statistics are notoriously unreliable. If firms had financial incentives to classify spending as R & D, the statistics could change dramatically.
- The linear idea that R & D drives innovation which in turns drives growth is discredited. Among other things, applied technology often precedes any deep understanding of the underlying theory.
- More spending on R & D is not obviously better; as with any investment there may be diminishing returns.
- New Zealand will have comparative advantages in some R & D activities but not in most. New Zealand firms benefit from domestic and overseas R & D. Local investment in R & D will always be minuscule on a global scale.
- Government R & D spending and subsidies may displace private sector spending.
- Business R & D has increased with the moves away from a protected economy and has been growing strongly: the latest figures indicate a compound annual growth rate of 6.2% from 1990 to 1997.

Governments typically fund basic or public good research. This is because the benefits of new knowledge cannot be fully captured by individual firms, hence they will not make the necessary investments.

Even the case for public good science is not straightforward, however. It has been challenged, both theoretically and in practice, with research such as Celera Genomics' human genome project. Moreover, the deadweight costs of taxation raised to fund government R & D spending and 'government failure' associated with political distribution of research funding need to be taken into account.

There is no doubt that science and technology are crucial for economic growth, and innovation even more so. Spurred by competition, firms will have incentives to invest in appropriate R & D. Depreciation and other tax rules for such investment should be efficient but where firms can capture the benefits of R & D, there is no good case for public subsidies.

Government policy can best assist R & D and innovation through low taxes, avoiding anti-technology regulation, focusing on appropriate public goods including basic research, and protecting intellectual property rights.*

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Part VI

2002

ICT report lacks policy framework

A New Zealand curiosity is the habit of prescribing plans or targets for industries or the economy. The Soviet Union and India used to have 5 and 10 year plans, eg for steel production. They were not good models.

The recent draft report of the Information and Communications Technology (ICT) Taskforce is a planner's document. It wants to see the ICT industry account for 10% of GDP in 10 years' time, up from 4.3% today. The target for employment is 125,000 jobs compared with the current figure of 41,000. To achieve these goals, 100 new ICT companies with annual sales of $100 million each are said to be needed.

The report acknowledges that the Taskforce is not a policy-based group – it comprises industry representatives.

That is a pity. The report suffers for lack of a policy framework.

An industry or a country is not a company. It can make sense for individual businesses to set targets: those running them can direct resources to implement their plan. Their success will be determined in the market place.

For an industry or a market economy there is no such thing as a business plan. No one in an ICT industry of nearly 8000 firms can direct its resources, let alone dictate the fortunes of the wider economy. That is why successful economies rely on decentralised decision-making in markets. Their governments focus on the framework within which firms operate.

Moreover, the Taskforce's targets look implausible and incoherent. They envisage an ICT sector proportionally larger than that of the United States, and exports equivalent to those of two dairy industries.

They also imply low levels of labour productivity growth in the industry – less than 1% a year if the economy grows by 3% a year. On this basis investors might be unwise to put resources into ICT when productivity growth in industries such as agriculture has been much higher.

Managers should be focusing on profitability or economic value added, not firm or industry growth for its own sake.

The Taskforce makes some useful points on commercial realities, such as access to capital and the management problems ICT firms encounter once they reach a certain size.

It also makes some points on policy that are sound, such as the need for skilled immigration, the case for relaxing rules relating to tax losses, and the rejection of R & D tax subsidies. It mentions the problem of rigid pay rates in the education sector which make it difficult to attract relevant teaching staff, but fails to note general problems of employment law, regulations and taxation. Low taxes and

business-friendly labour laws have been key factors in Silicon Valley's success. The problems of ICT management in the public sector are also treated lightly.

The ICT industry should have a bright future in New Zealand. However, it does not call for special treatment, and its fortunes will be materially affected by the quality of management of the economy at large. Further work should focus more on the overall economic framework and shortcomings in the government's current strategy for meeting its growth objectives.*

*First published in *The Dominion Post* on 2 December 2002.

Glossary

ACC Accident Compensation Corporation

APEC Asia-Pacific Economic Cooperation

ASX Australian Stock Exchange

CER Australia New Zealand Closer Economic Relations Agreement

CPI Consumers price index

CTU Council of Trade Unions

ECA Employment Contracts Act 1991

ERA Employment Relations Act 2000

FRA Fiscal Responsibility Act 1994

FTA Free trade agreement

GDP Gross domestic product

GST Goods and services tax

ICT Information and communications technology

ILO International Labor Organization

IMF International Monetary Fund

IRD Inland Revenue Department

MAF Ministry of Agriculture and Forestry

MMP Mixed member proportional electoral system

MP Member of parliament

NCEA National Certificate of Educational Achievement

NZBR New Zealand Business Roundtable

NZIER New Zealand Institute of Economic Research

NZS New Zealand Superannuation

NZSE	New Zealand Stock Exchange
NZX	New Zealand Exchange Limited
ODT	Otago Daily Times
OECD	Organisation for Economic Co-operation and Development
PPP	Purchasing power parity
R & D	Research and development
RBNZ	Reserve Bank of New Zealand
RMA	Resource Management Act 1991
SOE	State-owned enterprise
UE	University Entrance (certificate)
WTO	World Trade Organisation

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