THE NEXT DECADE OF CHANGE

NEW ZEALAND BUSINESS ROUNDTABLE
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FOREWORD

This collection of speeches and articles is the seventh in a series produced by the New Zealand Business Roundtable. The previous volumes in the series were *Economic and Social Policy* (1989), *Sustaining Economic Reform* (1990), *Building a Competitive Economy* (1991), *From Recession to Recovery* (1992), *Towards an Enterprise Culture* (1993) and *The Old New Zealand and the New* (1994).

The material in this volume is organised in five sections: economic directions; fiscal policy and the public sector (which includes a paper by Bryce Wilkinson, consultant to the NZBR on roading); education and the labour market; commercial law and regulation (which includes a paper by Denis Hussey, consultant to the NZBR on agricultural marketing policy); and miscellaneous.

A full list of NZBR publications is also included.

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THE NEXT DECADE OF CHANGE

Last month there was a spate of commentaries marking the anniversary of the election of the Labour government in 1984 and reviewing a decade of change in New Zealand. There was overwhelming agreement that the changes were mostly for the better and that the clock would not be turned back.

An editorial in *The Evening Post* was typical. "The verdict on a decade of radical reform has to be a positive one," it said. It observed that the social fabric had not been rent by the disappearance of hundreds of cosy but inefficient post offices, overseas travel was no longer a bureaucratic exercise governed by daily currency limits, shops were stuffed with all manner of competitively priced goods, and relaxed liquor licensing had encouraged more civilised drinking habits. The editorial concluded:

> New Zealand ... has largely shrugged off its suffocating dullness and dreary provincialism.

Overseas commentaries were similar. Rowan Callick, writing in *The Australian Financial Review*, said:

> The path of economic reform on which New Zealand ... set itself has become a model for many other countries. ... [T]he interest in the Australian business community about the continuing, unfolding New Zealand economic revolution is massive.

The fact that the changes listed by *The Evening Post*, and many others, have been of real benefit to ordinary people is no longer denied. Yet its Wellington stablemate *The Dominion* and many other media spent several years lambasting the changes, decrying "mad monetarism," "scorched earth policies," "trickle-down" theories, governments that had been captured by so-called elites, and the absence of any light at the end of the tunnel.

Now even polls in *The Listener* show that most people are happier with their lives than they were in the 1980s and are proud to be New Zealanders. Other polls confirm that a large majority believe New Zealand is on the right track and that present policies should be maintained or taken further.

New Zealand certainly did not get it all right. The failure to control government spending and borrowing and to free up the labour market at an early stage made life for many industries very harsh, particularly those striving to meet international competition. The Labour government's loss of direction and momentum caused much unnecessary hardship. All our experience, and that of other countries, indicates that the reformers who called for bold, comprehensive and rapid change to limit the adjustment pain were undoubtedly correct.

We are seeing this experience confirmed in Eastern Europe and the ex-Soviet Union today. The fast adjusters such as Czechoslovakia are through the worst of their difficulties whereas gradualists or non-reformers such as the Ukraine are in desperate trouble. Mart Laar, Prime Minister of Estonia, one of the fast reformers, recently noted that the advice from many Western experts was to 'soften' reforms, to spend more on social welfare, and to go in for less shock and more therapy. His response was: "I could not disagree more." Estonia has reduced its inflation rate from 1000 percent to 3.5 percent last year, increased its exports to the West 15 times over in the last few years, established the lowest tax rates in Europe and is now enjoying Europe's fastest growth rate.

The Estonian prime minister contrasted this experience with the difficulties in Russia where reforms have been halting and inconsistent:

> Estonia's experience clearly demonstrates that only radical and systematic reforms can ensure a better future for a country emerging from central planning.

The lesson is clear. Policies which are often described as 'harsh' and 'austere' deliver the social benefits far more successfully than populist programmes which purport to have more regard to 'people factors.' We should not confuse the rhetoric with the reality.

It is useful to remind ourselves that New Zealand has not been the only country undergoing major economic changes in the last ten years. The Thatcher and Reagan revolutions, the worldwide move to privatisation, the creation of the single market in Europe, the resolution of the debt crisis and the opening up of Latin American economies, the fall of the Berlin Wall, the continuing success of East Asia and the spectacular ascent of China have changed the face of the international economy.

It is unlikely that the changes in the next ten years will be any less dramatic. The structural changes to the world economy resulting from the rise of countries like China and perhaps India will be as large as those of the Industrial Revolution. New Zealand will not escape the consequences. Only if we remain flexible and competitive and keep adapting will we maximise the benefits from these changes and minimise the costs.

The short-term outlook for New Zealand is extremely favourable. However, I have been in business long enough to know that circumstances can and almost certainly will change. It would be utterly irresponsible to risk going into the next downturn with our levels of debt and unemployment as high as they are now. There is no latitude to relax efforts to get on top of these problems.

There is plenty that politicians can do to reduce the risks.

The main strategy for debt reduction must be to run sustained fiscal surpluses. It was encouraging that much media commentary after the budget endorsed this priority. However, the planned increase in government spending this year was higher than markets were expecting and the size of the surplus was below market expectations. As a result there will be marginally more pressure on monetary policy and on our internationally competing industries. There is no scope for slippage in the fiscal projections, and the government must strive to improve on them by further reducing low quality expenditure.

There is also a strong case for reducing debt faster by moving ahead with privatisation. While New Zealand is marking time, other governments, both central and local, are getting out of running commercial businesses at a rapid rate. There are still those like the Auckland Regional Services Trust who claim that governments can run businesses as efficiently as the private sector. However, the evidence is now clear that, on average and over time, this claim is simply wrong. A recent World Bank paper asked the question: "Is privatisation necessary?" and said:

> The answer is a decided "yes." Privatisation is necessary, and not simply to improve performance of public enterprises - though the evidence is striking that it can and does improve performance. Privatisation's essential contribution is to "lock in the gains" achieved earlier by reforming public ownership ... ; to distance the firm from the political process; and to inoculate the company against the recurrence of the common and deadly ailment of

public enterprises: interference by owners who have more than profit on their minds.

Evidence from New Zealand and elsewhere shows that ownership matters: privatised firms achieve additional productivity gains and can grow and evolve to meet changing market demands in a way that is simply not possible under government ownership.

As regards unemployment, we are fortunate to have the results of a major OECD inquiry available at a time when a government task force is examining the problem. Its basic policy message strongly endorses the approach New Zealand has been following. The OECD dismisses technology as a cause of unemployment and is emphatic that the answers do not lie in protectionist measures, enforced work-sharing and training levies - proposals that are still canvassed in this country. Instead, it stresses the need for a stable macroeconomic environment and for labour market flexibility along the lines of the Employment Contracts Act. Of particular interest, given the evolution of New Zealand's policy, it also argues for:

- reforms to statutory minimum wages, which it says are damaging to employment opportunities, particularly for unskilled labour;

- looser restrictions on dismissals rather than the increased constraints which have been introduced by our Employment Court; and

- restrictions on open-ended benefits given the evidence that they are clearly a factor in long-duration unemployment.

Very much the same messages are coming from Asian sources. As Prime Minister Goh of Singapore recently told an international audience:

> ... the labour markets, especially in Europe, have become too rigid and inflexible. Strict employment protection laws have discouraged employers from recruiting new employees. Generous benefits for the unemployed reduce their incentive to work. High minimum wages cost young workers their jobs.

Thanks to the ECA and other reforms, New Zealand now has in place the basic framework for a strategy to bring down unemployment. Since the ECA was introduced, 70,000 new jobs have been created and 90,000 additional jobs are forecast over the next three years. This rate of employment growth is amongst the highest in the OECD. Contrary to recent claims by the Council of Trade Unions, reductions in unemployment must continue to have priority over wage increases where labour is in plentiful supply. It is extraordinary that those who purport to speak for the unemployed are not the most vocal critics of proposals to change the ECA. Moreover, the OECD report points clearly to ways in which our labour market can be further improved.

Many journalists and political commentators, focusing on the short-term state of New Zealand politics, would tell you that measures such as the OECD recommends to deal with unemployment, or further significant privatisation initiatives, are not on the political agenda. Many focus on the make-up of party caucuses and current policies and imagine these are fixed and unchanging. Experience suggests that nothing could be further from the truth.

What such people overlook is that the fate of new ideas usually goes through several phases. Initially proposals that challenge the status quo are not just rejected but jeered at and abhorred. Then as problems prove resistant to other solutions, the new ideas are acknowledged to be theoretically valid, but of course politically impossible in practice. Finally, they get absorbed into the thinking of political parties and become the conventional wisdom, or in today's terminology the consensus view. I expect we shall see this process at work in the next ten years as often as we have in the last decade.

Take the idea of a time limit on the dole, which would no doubt be backed up by a requirement to go on to training or accept other work that was offered. When the Business Roundtable first considered this idea in 1988 it rejected it on the grounds that such a rule would be unfair given the rigid labour market of the time and the inability of job seekers to price themselves into work. Following the labour reforms, and with employment now much more freely available, we have promoted the idea, and were initially greeted with howls of outrage from the predictable quarters. Yet last month *The Herald* wrote in an editorial:

> Given that the dole is designed primarily to provide short-term income support, there seems much merit in that suggestion.

Such a policy is widely applied in other countries, and it would be surprising if it were not adopted in New Zealand within the next ten years.

What else might happen in that period? The answer is a great deal, if New Zealand is to capitalise on its recent achievements and keep pace with developments in the rest of the world. Lee Kuan Yew observed recently that New Zealand and Australia had lost twenty years before they took steps to arrest their long-term economic decline. A country that succumbs to 'reform fatigue' is taking great risks with its future.

We can get some idea of what the next ten years might hold by looking at trends elsewhere. The 1980s were a decade in which the size of the public sectors in most economies peaked and the trend now is clearly towards smaller government. New Zealand is moving with this trend, with the budget projecting government spending to fall well below 30 percent of GDP by 2000. Tax rates will fall in sympathy; it would not be surprising to see marginal income tax rates below 20 percent in this period.

Privatisation will surely continue apace. Few governments around the world are now involved in electricity supply; even China is floating some of its electricity companies on the stock exchange. Britain, Sweden and Malaysia seem likely to be the first to privatise postal services. Forms of privatisation of utilities such as roading and water are certain to be on the agenda of more countries before the decade is out.

When we hear a Democratic president in the United States pledging to "end welfare as we know it" and proposing a two-year limit on welfare payments, we can be fairly sure that welfare systems will be a major area of change. Similarly, I cannot imagine electorates tolerating unemployment rates of 7-8 percent, as are still projected in New Zealand, when the policy solutions to the problem have been quite clearly laid out.

Around the world, reforms have been slowest to materialise in social services such as education and health. The trend towards educational choice is now moving strongly, however, and widespread use of education vouchers and greater private provision and financing seems likely. In health, the government of the Czech Republic is planning to transfer 70 percent of public hospital beds to the private sector by 1996. Technological developments are likely to force the pace of change in health and education.

Some special New Zealand institutions have clearly passed their use-by date. The chances of our monopoly accident compensation scheme and our monopoly producer boards surviving the next ten years are remote.

What we also know is that the changes that will occur over that timespan will be greater than we can foresee now. By and large I expect they will be welcome ones. The world seems set on a course of market-oriented growth. The major international tensions have subsided. Contrary to a good deal of myth-making, the world is not threatened by environmental crises. It is approaching the new millennium in good shape.

New Zealand must work hard to ensure it stays on course to enjoy better fortunes.

We in the private sector have a major responsibility to strive for excellence in our businesses, raise our management performance and upgrade workplace skills. In the political sphere, the new electoral system need not be an obstacle to progress. Much more important is whether our political parties can reach a broad consensus around a sound policy framework and take opportunities to extend it.

This will only happen if ideas are developed and debated in the wider community. Politicians will only fight on ground that has been well prepared. The business community has to help prepare that ground. In the last ten years, reforms have had to be dug in the rock-hard ground of widespread misperceptions of how a successful market economy works. Now the media and the public are more economically literate, the evidence of success is all around us, and there should be a receptive climate for further progress.

If we in the business community and other groups do our work well, I see no reason why editorials in ten years' time will not record that New Zealand made at least as much progress in the next ten years as it has in the last decade.

CONGRESS '94 ECONOMICS
THE ENTERPRISE NEW ZEALAND TRUST

THE GOVERNMENT'S ROLE IN ENTERPRISE, EMPLOYMENT AND GROWTH

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THE GOVERNMENT'S ROLE IN ENTERPRISE, EMPLOYMENT AND GROWTH

> [A] wise and frugal government, which shall restrain men from injuring one another, which shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned ... . This is the sum of good government.
>
> Thomas Jefferson

Introduction

The other day I was reminded of the vast complexity of arrangements which underpin seemingly simple everyday transactions.

I frequently use courier services but don't think much about them. Normally, my only contact with a courier is a fleeting glimpse of a fast moving, brightly-coloured individual racing through a lobby. On this occasion, however, I had to send a report by overnight courier to another city in New Zealand. I was too late for the usual means of delivery, so I took the package directly to the base from which all courier parcels are assembled and despatched.

I stood for a moment intrigued by the hive of activity within the brightly-lit warehouse. An assortment of vans and cars surrounded trucks of various sizes. The people who were mere apparitions to me during the day moved around purposefully checking off items on clipboards. The largest of the trucks being attended to by forklifts were to be driven through the night to other centres. Other trucks were destined for the airport.

Being physically confronted with the scene caused me to reflect on the complex web of arrangements by which the report would find its way to its recipient's desk first thing the next day. Incorporated in that single transaction were the outcomes of a contract with the courier company, contracts between the courier company and individual couriers, office staff, warehouse workers, truck and van suppliers, airport operators and airline companies. This list is hardly exhaustive.

What intrigued me was that all this normally happened without either me, or the recipient, giving the matter a second thought.

An obvious retort is that this should be obvious if one pauses for more than a moment to think about what it takes to consummate everyday transactions such as buying petrol or posting a letter. However, the complexity and diversity of information embodied in day-to-day voluntary transactions has been something which has been overlooked in much traditional analysis of public policy.[1] This

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1 In commenting on the failure of collectivism as a means of coordinating economic activity in Eastern Europe and the former Soviet Union, Buchanan (1991) asked of economists "Why did so many professionals in choice analysis fail to recognise the informational requirements of a centrally controlled economy in both the logical and empirical dimensions?"

includes consideration of the ways in which governments can promote enterprise, employment and growth.

If the economic analysis underpinning government policy is poor, the policies put in place to promote enterprise and growth will not achieve their intended aims and may indeed produce the very opposite effect.

Traditional Approaches to the Role of Government

The traditional approach to welfare economics takes a model of perfectly competitive industry as the benchmark. In this model, prices which are determined in the market equal marginal cost. There are no transactions costs and all participants in the market are fully informed, that is, information costs are ignored.

Measured against this benchmark, voluntary transactions may lead to unsatisfactory outcomes, a situation often referred to as 'market failure'. Examples of market failure that are commonly suggested include:

- ***Externalities or spillovers***[2] Negative externalities arise whenever there is a difference between private costs and social costs. A common example is firms which do not bear the downstream costs of their pollution. Conversely, positive externalities exist whenever a private benefit is less than the social benefit. Wider benefits of education, for example the benefits to the community from basic literacy and numeracy skills, are often cited as examples of positive externalities.

- ***Public goods*** These are goods where it is difficult to exclude non-payers from enjoying the benefits of the goods and where the extra cost (and therefore the price) of providing such goods or services is very low or zero. In a narrow sense, the cost of providing street lighting for the extra passer-by would be zero.

- ***Inadequate competition*** Market failure may occur where competition is limited. A natural monopoly arises where a single firm can supply the output of an entire industry at a lower cost than two or more independent firms. In these circumstances, new entrants into the industry are discouraged. The firm may be able to set its price above marginal cost. Market failure is said to occur in the case of natural monopolies because it is too costly for new entrants to enter the market.

- ***High information costs*** Markets may be unable to operate well because of high information costs which result in 'incomplete markets'. For example, the high cost of establishing whether a person is truthfully revealing information about his or her health status may impede the market for health insurance.

The traditional approach to welfare economics seemingly provides the foundation for a wide and pervasive role for the government in promoting growth and employment. According to this view, externalities should be 'internalised' through taxes and subsidies. For example, the retention of subsidies which meet 80 percent of the costs of tertiary education has been advocated by some commentators on externality grounds. Public goods and natural monopoly arguments have been advanced to justify continued government provision of services such as roading and electricity. Many regulatory interventions have been suggested to address perceived market failures.

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2 Pigou (1962) is generally credited with being the first to formalise the concept of an externality.

Shortcomings of Traditional Approaches

Market failures appear to abound if real world markets are compared to the theoretical norms of perfect competition, which is characterised by price-taking behaviour and perfect markets, instantaneous market clearing prices and costless transactions. However, Nobel laureate Ronald Coase has observed that:

> The ubiquitous nature of 'externalities' suggests to me that there is a *prima facie* case against intervention, and the studies on the effects of regulation that have been made in recent years in the United States, ranging from agriculture to zoning, which indicate that regulation has commonly made matters worse, lend support to this view (Coase (1988)).

Close scrutiny shows that many claimed externalities and public goods do not satisfy the relevant criteria. Goods which display all the characteristics of public goods, for example, are rare if not non-existent, although many goods display some of their features.

The most profound shortcoming of traditional welfare economics, however, is its failure to take adequate account of the features of market transactions so apparent to us when we visit a supermarket or the warehouse of a courier firm.

The first feature is that information, like most other things, is scarce. Of particular importance is the information available to the 'person on the spot'. This includes the information each person who undertakes a voluntary transaction has about the particular circumstances bearing on his or her own decisions. This information may be known only to one person or a few people, is very diverse and constantly changing, is vast in quantity, is spread throughout all of society and is often hard to transmit or to aggregate in any meaningful way. The most important way in which this information is conveyed is through market prices. Using prices as a guide, people adapt to circumstances about which they have no direct information (Hayek (1945)).

Central planners do not have and cannot obtain much of the information that is conveyed through market signals. The omniscience implicit in traditional welfare economics, such as the attempt to address an externality through a tax or a subsidy, does not exist. In the absence of appropriate information, government policies aimed at correcting market failures through specific taxes or regulations can easily founder.

A related shortcoming is the failure of traditional welfare economics to take account of the costs of undertaking voluntary transactions, of which information costs are a part. In order to transact with each other, individuals and firms must bargain, define in a contract what is being transacted and monitor and enforce the contract. This involves costs which are known as 'transactions costs'.[3] Transactions costs may be defined as any obstacles to market exchanges that interfere with or discourage the process of transacting. When transactions costs are taken into account it may not be worthwhile for the government to do anything about either positive or negative externalities.

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3 Ronald Coase's major contribution to the economic analysis of the effects of government activities and regulations was to highlight the importance of transactions costs and property rights in influencing economic choices. See, for example, Coase (1988).

The Relevance of Public Choice Theory in Considering the Role of Government

Gains to individuals, households or firms provide the motivation for voluntary transactions. Because they are mutually beneficial, voluntary transactions are irrepressible. Individuals have strong incentives to use the marketplace to make themselves better off. For this reason, markets cannot really be suppressed but they can be distorted and emerge in a different form. This is as true of the 'political' marketplace as any other.

Changes in government policy can alter the environment within which firms operate and affect their profitability. In addition to commercial risks, firms face the possibility that government policies may not be stable and in any political system sovereign risk of this nature is important.

Proponents of government intervention often assume that the government has the knowledge and the desire to promote the general public interest. They see the state as a mechanism used by rational economic agents, including individuals and their associations, to maximise community welfare. This view implies that existing government programmes to promote growth, enterprise and employment are optimal.

Such an approach appears to leave little scope for economic reform. If there is no superior alternative to existing policies, how can public policy be improved? But if there is no scope for improvement, how and why does change occur in the political process?

Like traditional welfare economics, this view seems to discount the effect of both transactions costs and incentives. It is unlikely that politicians and government officials act solely to maximise community welfare without regard to their interests, power, prestige, income or voter appeal.

Individuals and groups have an incentive to lobby for favourable policies that benefit them at the expense of the community (a practice referred to as 'rent seeking'). Although most people are thereby harmed, the individual cost to each is small. Hence no individual has a strong incentive to lobby against favours granted to others or to alter his or her voting behaviour in the light of the concession. Efforts by lobbyists for special concessions are wasteful from a community-wide perspective because valuable resources are diverted from the production of goods and services to socially non-productive activities whose only purpose is to obtain a larger share of the economic pie.

While voluntary transactions may result in imperfect outcomes, the contribution of public choice theory shows us that government interventions can even more adversely affect community welfare. Indeed the same factors which lead to unsatisfactory voluntary solutions are also likely in many cases to make government-imposed solutions unsatisfactory. One commentator has observed that:

> ... there is a large body of professional opinion among economists, perhaps more among older than among younger ones, to the effect that markets left to themselves may turn in a pretty poor performance, but not nearly so poor when left alone as when tinkered with, especially when the tinkering is simplistically done or done cleverly to disguise the size and distribution of the costs or losses associated with some "innocuous" favoritism (Schelling (1981)).

Implications for the Government's Role in Enterprise, Employment and Growth

Do the complexity of market transactions, the shortcomings of traditional welfare economics and the adverse effects of rent-seeking behaviour imply that the government has no role in promoting enterprise, employment and growth?

Government policy has substantial effects on everyday business and personal choices through measures such as taxation, the monetary system, the provision of education and health, social policy and regulation. It will enhance or detract from growth and employment prospects through the effects such policies have on people's choices to save, invest, work and use their leisure. These choices will reflect their responses to economic opportunities and sanctions. Incentives operate everywhere and are an unavoidable consequence of government actions. Government policy can tilt, augment, dampen or create incentives that will induce people to behave in ways that are collectively more or less rewarding.

The objective of policy should, therefore, be to ensure that incentives created by government policies maximise the likelihood of economic growth, enterprise and employment. Which policies will best promote such an outcome?

- *Reducing the Costs of Transacting*

An important role of the government is to provide an environment in which the costs of transacting are kept to an appropriate level. Ways in which this is achieved include the definition and enforcement of property rights, procedures which enable contracts to be enforced, and rules against fraud, theft and violence. These protections encourage individuals to invest knowing that they will be able to benefit later on and that promises to exchange will be kept.

Without an adequate system for the definition and protection of property rights, individuals can use resources without paying for them and the resources will be over-exploited, reducing the amount available for others. Property rights are far more extensive than the mere ownership of bricks and mortar. The strength of a property right depends on:

- the extent to which the owner alone may decide on the use of a resource;
- the rights of the owner to extract income from using the resource; and
- the authority, if any, of the owner to transfer or sell the rights to the property or resource.

A secure system of property rights enables individuals to enter into transactions to transfer or modify rights in the light of the information to which they alone have access. Such a system is, therefore, usually better able to deal with the complexities of everyday business activities than imposed regulatory alternatives.

Policies which define and strengthen property rights can contribute significantly to growth. Just one example is the fishing industry where property rights have been allocated under a quota management system instituted in 1986. The new system led to a significant restructuring of the industry and resulted in higher profitability and employment. With better property rights, fishing companies were able to develop more stable markets. The regime enabled the rights of Maori to be crystallised and provided a mechanism for the obligations of the Crown to be met. The irony is that existing fisheries management mechanisms are weakest where property rights are less well defined, as is the case with the entitlement of recreational fishers to a share of the fisheries resource (Fisheries Taskforce (1992)).

The announcement of the Alliance spokesperson on housing that the Alliance Party would renationalise former state houses without compensation is an example of a policy which would increase uncertainty concerning all property rights and would be detrimental to growth in investment and employment.

Another way in which the government can reduce transactions costs is by providing procedures which facilitate the negotiation, settlement and enforcement of contracts. An important example is the Employment Contracts Act (ECA). Since the ECA's enactment, some 82,600 jobs have been created with employment growth now running at a far higher rate than was achieved with a highly regulated labour market. Interventions such as minimum wage laws cut across employment contracts and impede employment growth. If they have any effect at all, it is to keep the youngest and the least skilled employees from working at all.

- *Providing a Stable and Certain Policy Environment*

A stable and certain policy environment will promote growth, employment and enterprise.

An important element is stable and certain monetary and fiscal policies. Stability is important since expectations are shaped by perceptions about likely changes in prices and in overall government revenues and expenditures. Major swings in policy will increase the risks businesses perceive and reduce the credibility of government policies. This was a major problem which hampered growth prior to 1984.

Take taxation as an example. Current investment depends not only on the tax treatment of investment today but on how this treatment may evolve in the future. A lack of credibility makes effective policy change difficult, since people may discount announced policies. A climate of uncertainty associated with frequent policy changes can, itself, increase risks and reduce the attractiveness of long-term investment.

The credibility of government policy is enhanced by measures such as the Reserve Bank Act and the Fiscal Responsibility Act. These statutes require the government to make its monetary and fiscal targets transparent, thus increasing the political costs to it of any significant and unannounced change in policy.

Another important element of stability is a policy environment in which firms can compete without being favoured or disadvantaged by government-imposed measures. This has the obvious advantage of reducing incentives for valuable resources to be wasted on lobbying compared to expanding market opportunities.

A competitively neutral environment for business also has less obvious but equally important benefits in promoting enterprise. If, for example, an entity is favoured or discriminated against by government interventions, there can be difficulties in establishing benchmarks to assess the performance of managers. Poor managers may appear to be good ones only because they are sheltered from normal commercial disciplines. In contrast, the good performance of competent managers may be overlooked if the entity is operating in an environment where it is handicapped.

A typical example is the meat industry. Given the raft of regulations and interventions suffered by the meat industry over the last twenty years, what assurance is there that the least enterprising companies are closing down while the most competent are flourishing?

- *Reducing the Size of Government*

In the 25 years from 1950 to 1975, central government expenditure averaged about 22-25 percent of GDP. Since that time, it rose to reach a peak of over 40 percent of GDP. Central and local government expenditure as a proportion of GDP will be at least 38 percent in 1994/95, or about $29,000 per household.

Excessive public expenditure hampers longer-term prospects for sustainable growth in employment and incomes for several reasons:

- government expenditure can crowd out private expenditure that would provide higher benefits to the community;

- government agencies generally face weaker incentives to be efficient and responsive. They tend to produce goods and services that are difficult to measure and are unpriced, such as health care. Funding for the monopoly agency is provided from taxation. Without prices and competition, there are reduced incentives to provide what consumers want, to innovate or to minimise costs of production, and consumers have no adequate benchmark against which to measure quality. Government agencies cannot be declared bankrupt, and government guarantees can perpetuate costly and inefficient bureaucratic practices; and

- expanded government expenditure must be funded through either current or future taxes. Because people alter their behaviour in response to taxes, they reduce output and incomes by discouraging work effort, investment, and the willingness to bear risk, and they adversely affect a host of choices which people face every day.

The increase in government expenditure in New Zealand corresponded with a period of consistently poor economic performance. This pattern was typical of most developed countries. Nobel laureate Gary Becker has observed that:

> National plus local government spending in some 50 non-communist countries went from an average of about 32 percent of GDP in 1972 to 36 percent in 1980 to 40 percent in 1985. I believe this contributed to the sharp decline in world economic growth in the 1970s and 1980s from the previous two decades (Becker (1993)).

The size of government can be reduced by pruning expenditure where benefits are captured substantially by relatively high income groups (such as tertiary education subsidies) and eliminating non-core activities, such as those which can be undertaken by the private sector. The latter could be achieved by selling remaining state-owned enterprises.

- *Reducing Unnecessary Regulation*

New Zealand still maintains many economically costly regulations and in some areas we have been adding to them.

Probably the most damaging regulations applied by any country are those restricting foreign trade. While we have made progress in removing import restrictions, we still have a long way to go. The GATT secretariat assessed New Zealand's average pre-Uruguay Round trade-weighted tariff for industrial goods at 22.7 percent. The corresponding post-Uruguay Round figure is expected to be 13 percent. The average figure for the developed world is 6.3 percent, falling to 3.9 percent following the Uruguay Round. Tariffs are a tax on exports which hamper growth.

In addition, comprehensive regulations still apply to the marketing of our major agricultural exports which account for nearly half our export trade. If these ever made sense when almost all of our exports went to Britain, often under government contracts, they make no sense today. The need in the 1990s is to be part of the highly competitive food business, particularly in the growing markets of Asia where producer boards are unheard of as commercial entities.

Within the domestic economy, many inappropriate regulations remain. Controls on pharmacy ownership, licensing trusts and the monopoly TAB, for example, have few if any counterparts overseas. It is becoming clear that the Resource Management Act is adding significantly to some of the costs of doing business, and has not succeeded in some if its aims, for example disallowing trade competition as an argument for objecting to a planning approval.

Conclusion

The complexities of the decisions which businesses and individuals make every day are self-evident but have profound implications for the role of the government in promoting enterprise, employment and growth. Politicians and officials cannot have access to most of the information upon which people trade.

Information problems and transactions costs in political and other markets have still to be fully appreciated. This is reflected in statements still heard at seminars where important issues of public policy are debated. The first question often asked is: "What sort of society do we want?" In the sense in which it is posed, that question is only relevant if people can be moved around a chessboard like pawns by all-knowing and public-spirited policy makers and politicians.

Achieving the desirable goals of sustainable increases in growth, enterprise and employment cannot be achieved by governments seeking to second-guess the outcomes of voluntary transactions. A climate where individuals and firms make choices which increase overall community welfare is fostered by a government which, to update Thomas Jefferson, "sticks to its knitting". This is achieved by the government pursuing its social and economic goals in ways that foster a stable and certain policy environment, that encourage an efficient use of resources, and that leave individuals and businesses largely free to "regulate their own pursuits of industry and improvement."

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NEW ZEALAND SOCIETY OF ACCOUNTANTS
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THE WAY WE WERE AND THE WAY FORWARD: A BUSINESS PERSPECTIVE

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ROTORUA
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THE WAY WE WERE AND THE WAY FORWARD: A BUSINESS PERSPECTIVE

I began my talk at your conference in 1989 AD (After Douglas) by reflecting on the way we were five years earlier. I recalled the predicament of my friend Roderick Deane who had been asked to propose a toast to the market economy early in 1984. That great unmentionable, the market economy, had not been heard of for years in New Zealand, and there was very little to toast.

It is salutary to recall what others had to say about us at the time of the 1984 election.

The British newspaper *The Guardian* told its readers that under nine years of Sir Robert Muldoon's increasingly autocratic and eccentric rule, "New Zealand learned to live beyond its means as it had never done before". Its welfare state and budget deficits had swelled under the tutelage of "the political Mr Micawber of the southern hemisphere".

The Economist was also clear that the "blame for the hard times ahead rested squarely with Sir Robert Muldoon," and forecast that the economy would go into recession and perhaps shrink. It wrote:

> Sir Robert was usually branded a "right winger". ... In economic terms, though, he was as much an interventionist as any Marxist dreamer or socialist soldier. Markets were there to be suppressed or ignored, businessmen to be bullied. His government tried to spot winners, choosing projects so big they would make a Brazilian blush.

The Economist added that, like other third world leaders who had fouled up their economies, and like some politicians and church representatives today, Sir Robert was fond of claiming that he was "on the side of the people". It correctly stated that "New Zealand will now have to pay for the nine years of Sir Robert Muldoon's populism".

Last month, an editorial in the *Wall Street Journal* looked back over ten years of reform in New Zealand. It summed up the essence of the changes this way:

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

It is interesting to contrast that view with those of opponents of the reforms who still mindlessly repeat the charge that the changes favour 'the rich' at the expense of 'the poor'.

We met here in 1989, half way through that decade of change. I argued that what had happened was hardly a revolution and certainly not an experiment. All New Zealand had done was get somewhat closer to the real world and the mainstream policies of successful OECD countries. The lessons of sound economic management, I suggested, were fairly simple:

> To cure inflation, you stop printing money. To stop piling up debt, you balance your budget. If you want economic growth, you keep your government spending and tax burdens low and your economy open and competitive. If you want full employment, you free up your labour market and make sure your welfare safety nets don't turn into hammocks for people to lie on.

The thrust of my remarks in 1989 was that while we had taken on board some of these lessons, we had not taken on board enough, and as a result both the economy and the government were floundering. Company taxes and GST had just increased, government spending was continuing to rise, the privatisation programme was grinding to a halt and the Labour government was unable to overcome the vested interests in its own ranks opposed to labour market deregulation. I argued that we were still stuck with mediocrity and that the economy could get worse before the next election. As *The Economist* might have put it, "blame for the coming recession and rise in unemployment lies squarely with those who have called a teabreak on reform".

Nevertheless, I said I was an optimist for New Zealand in the 1990s. I thought we had a good chance of achieving the best economic performance we had seen for decades because New Zealanders had become fed up with living in a third rate country and with politicians who had kept it in that state.

So events have turned out. Thanks in particular to Ruth Richardson and those in the government elected in 1990 who supported her views, we took on board more of the lessons of economic success. The key initiatives which have made the economic policy framework more coherent were tighter fiscal discipline, the deregulation of the labour market and a start on welfare reforms. Had these been implemented earlier, we would have had less pain and reduced the adjustment timetable by four or five years. But there is no point in crying over lost opportunities in the past. The only worthwhile lesson is not to lose opportunities in the future.

It is worth underlining the extent of the turnaround in New Zealand's economic fortunes. Two sets of comparisons illustrate the change.

First, we can look at the ten years that have elapsed since 1984 and compare the record with the nearly ten years of Muldoonism that preceded them. Were they years of all pain and no gain as the critics contended? The facts indicate otherwise. In the ten years 1984-94, the economy actually recorded average annual real growth in GDP of 1.6 percent, a slight increase on the 1.4 percent rate in 1974-84, despite the massive restructuring and the teabreaks. So on that basis alone the Cassandras had it wrong.

Second, and of course more relevant, are our future prospects. The OECD released its latest economic outlook in June. It revealed that for the three years to 1995:

- Real GDP in New Zealand is expected to grow by 13 percent compared with 7 percent for the OECD as a whole;

- Capital formation in New Zealand is forecast to grow by 30 percent compared with 13 percent for the OECD as a whole;

- Unit labour costs in the business sector, a basic measure of competitiveness, are expected to stay broadly stable in New Zealand - with ongoing increases in productivity - but rise by 5 percent in the OECD as a whole;

- Consumer prices in New Zealand are expected to rise by under 5 percent, just over one third of the OECD rate;

- Employment growth in New Zealand is expected to total over 5 percent compared with 1.5 percent in the OECD as a whole;

- Unemployment is expected to come down to 8.1 percent of the labour force in New Zealand, below the OECD average of 8.3 percent and well below the European rate of nearly 12 percent; and

- New Zealand is expected to be running a budget surplus of nearly 3 percent of GDP in 1995/96 whereas OECD countries are expected to be running deficits of over 3 percent on average.

The consistency of this set of figures is such that it is no longer possible for the opponents of reform to insist that the achievements have been negative. As Paddy McGuinness, a leading Australian economic commentator, wrote after a recent visit to New Zealand:

> ... the critical spotlight is at last turning away from the reformers ... and towards the chorus of Cassandras who opposed all change and fiscal responsibility from the beginning.

McGuinness noted that these were mainly the second rate economists in university economic departments. He suggested that it was time for their "idle vapourings" to be ignored and for the current messages of the reformers to be heeded.

The main message that the reformers are putting out today is that, as in 1989, we risk having another political teabreak and missing another set of opportunities.

Back in 1989, as I mentioned in my speech, the government had decided to drop plans to deregulate postal services. We are no further ahead today. We were debating electricity industry reform then and we are still debating it. I noted that in 1989 the British government had privatised its water supply. No political party in Britain wants to go back on that decision, but despite the fiasco in Auckland we have not even begun to think about it. Our absurd state monopoly accident compensation scheme is still described by many as the envy of the world; it does not seem to occur to them to wonder why no other country has copied it. I could go on. The list of policy areas where New Zealand lies well outside the OECD mainstream remains a very long one.

Moreover, as many commentators have remarked, the OECD group of countries is no longer the relevant benchmark of economic success. They are being rapidly overtaken by countries in the Asian region. Hong Kong, a desperately poor country when I first visited it in 1962, now has a per capita income 25 percent higher than New Zealand. The small government, pro-business, anti-welfare countries of Asia are setting the pace for the rest of the world.

It is ironic that there are still politicians like Winston Peters who think that Asian success is due to state direction of their economies. Someone should take him on a trip to China which is rapidly becoming the greatest showcase of capitalism on earth - despite state control, not because of it. The simplest measure of the extent of government intervention in any economy is the size of its public sector. All the dynamic East Asian countries have relatively small government sectors - often half the size of those in Europe where government spending typically accounts for 40 percent or more of the economy. Those Asian countries that relied more heavily on interventionist policies in earlier years are now deregulating and privatising fast.

In my remaining time I want to concentrate on three areas where New Zealand remains well behind the pace and where we are doing too little to catch up.

The first is government spending and taxation. On a comparative scale, we are still much closer to the high-tax European economies than the low-tax economies of Asia. Government net financial expenditure is going up by 3.7 percent this year in real terms. Such a rise would have been strongly criticised in earlier years. Despite strong growth, the expenditure to GDP ratio will barely fall. The financial surpluses and reduced debt ratios projected in the budget are far from in the bag. They depend critically on the continuation of strong economic growth and firm control of expenditure. We could make faster progress and reduce the risks to which the economy is exposed by moving ahead on privatisation and reducing government spending in low priority areas.

High levels of government spending inevitably mean high levels of taxation. The accountancy profession is well aware of the economic costs of taxation and we ought to hear more from you about them.

The beginning of the story is that we employ nearly as many people in Inland Revenue to collect taxes as we employ in the police force. However, far more resources are employed in the private sector complying with the tax system. One recent study found that compliance with business taxes alone took up 46.5 million person hours or the equivalent of an annual working year for over 20,000 people.

But these costs are only the tip of the iceberg. Far more important are the so-called 'deadweight' costs of taxation. The name refers to the drag that taxes impose on the community's living standards because they alter incentives to work, save, invest and take entrepreneurial risks.

A recent study commissioned by the Business Roundtable found that the marginal costs of taxes on income from labour (mainly income tax) and on consumption (primarily GST) are around 18 percent and 14 percent respectively. The findings imply that, at the margin, an additional dollar of government expenditure needs to yield net benefits of $1.18 and $1.14 to be justified. It is a safe bet that not many marginal government projects yield benefits of that order. For a marginal reduction in government expenditure of a billion dollars, national income would be higher by $140-180 million dollars. It is also a safe bet that the deadweight costs of taxation of capital income are much higher, particularly in today's open economy.

I would like to see the Society of Accountants setting aside any vested interest in tax administration and explaining to the public the enormous benefits of lower taxes. The government's plans to cut taxes once debt is reduced to prudent levels would be very positive for the economy. With the continuation of present fiscal trends we have the prospect of moving back to the situation of 50 years or so ago when those on moderate to low incomes paid little or no tax.

The second area where New Zealand is still falling short is government regulation. Most people now accept that we were an extraordinarily over-regulated economy. What is less appreciated is that we still maintain many economically costly regulations and in some areas we have been adding to them.

Probably the most economically damaging regulations applied by any country are those restricting foreign trade. While we have made progress in removing import restrictions, we still have a long way to go. As *The Herald* pointed out recently, New Zealand's average industrial tariff rate is still about 12 percent; the average figure for the developed world is 6.3 percent, falling to 3.9 percent following the Uruguay Round. Tariffs are a tax on exports, and this tax in New Zealand still amounts to a burden of hundreds of millions of dollars a year on our export industries. It is probably no coincidence that in the three years to 1995 New Zealand's export growth is expected to be only around the OECD average whereas we are outperforming the OECD on most other indicators.

Import restrictions are particularly damaging for a small economy. Small Asian economies like Hong Kong and Singapore removed all such restrictions many years ago and have much higher ratios of imports and exports to total production than New Zealand.

There should be no exceptions to the process of removing tariffs and treating all industries in an even-handed way. Singapore removed protection on its motor vehicle industry and it proved unable to compete. While I confess that many years ago I tried to build a New Zealand motor car, I believe this industry should go the way of industries like TV assembly if it is unable to meet import competition without assistance. Otherwise every other industry in the economy, most of which now have to stand on their own feet, is burdened with higher costs and made less competitive.

On the export side of the trade restrictions ledger, we have made much less progress. Comprehensive regulations still apply to the marketing of our major agricultural exports, which account for nearly half our export trade. If these ever made sense when almost all of our exports went to Britain, often under government contracts, they make no sense today. The need in the 1990s is to be part of the highly competitive international food business, particularly in the growing markets of Asia where producer boards are unheard of as commercial entities. The idea that one monopoly board can effectively service a market of a billion consumers in China is ludicrous.

A number of government MPs will tell you privately that they cannot see the economy continuing to grow by more than 3-4 percent a year while these restrictions remain in place, and I agree with them. As far as I can judge, however - and I hope I am wrong - the government has no intention of doing anything about the problem. The question we should be asking is : Why not?

Within the domestic economy, many of the features of old New Zealand still survive. Controls on pharmacy ownership, licensing trusts and the monopoly TAB, for example, have few if any counterparts overseas. It is becoming clear that the Resource Management Act is adding significantly to the costs of doing business, and has not succeeded in aims such as eliminating trade competition as an argument for objecting to a planning consent. Bureaucrats are still laying down whether you can grow trees on your land or use it for farming. Small builders will tell you horror stories about the complexity of the latest building and fire regulations. The Employment Court is doing its best to put businesses off employing people at all. The government has established a committee to look into ways of reducing the mounting burden of compliance costs. In my view, a more fundamental approach to government regulation, along the lines of the Fiscal Responsibility Act, is needed.

A third area where New Zealand has only started down the path of reform is welfare and social services. Again, the contrast with Asia is striking. Asians visiting New Zealand cannot comprehend our welfare culture and our rates of family breakdown, illegitimacy and crime. Unemployment, particularly long-term unemployment, is almost unknown in the successful Asian countries. Their competitive education systems, in which private education plays a greater role, are outperforming those of the West. Lee Kuan Yew's standard message is that the only forseeable threat to Asian progress is the development of Western-style welfare states.

I have to admit I have come full circle on the subject of welfare. In the days when many people used to believe in planned economies and government ownership of businesses, I used to believe the welfare state was one of humanity's greatest inventions. How could one resist the notion that the small amount of real poverty and misfortune that used to characterise our societies could not be fixed by a modest amount of state welfare? Surely all fair-minded New Zealanders wanted to give disadvantaged groups like Maori a helping hand? Who could begrudge spending, say, 5 percent of our national income on welfare programmes, especially at a time when New Zealand was still in many ways a developing economy?

The trouble with this belief of mine, like the other socialist beliefs that have come crashing down in ruins, is that it was mugged by reality. As our national income doubled and then trebled from the time welfare was introduced, and the distribution of income became more even on average, the welfare problem could have been expected to become smaller and smaller. Instead, it multiplied. I watched with horror as welfare spending grew from 5 percent of national income to double and triple that share. The same thing was happening in the United States and elsewhere. The more money that was thrown at the problem, the greater the problem became. Americans declared war on poverty in the 1960s and found by the 1980s that poverty had won.

What had gone wrong? Why had a noble dream turned into a nightmare? Slowly the reasons began to dawn on me.

One set of explanations came from a reading of early accounts of the development of the welfare state. Its architects were very conscious of the dangers of state welfare. By present-day standards, they were extremely conservative. They were aware of the risks of undermining the work ethic. They wanted to tie aid to efforts on the part of those receiving it to get back on their feet. They worried about weakening family responsibilities and supplanting the role of the church and other voluntary groups. They would have been horrified at the growth in state welfare beyond the prudent boundaries they sought to establish for it, and at the mutation of reciprocal obligations into rights. They would have been appalled to hear today's church leaders call on the government to be the primary source of help to families in need.

A second set of problems arose out of the need to finance expanding welfare programmes and growth in other government outlays. Tax burdens grew remorselessly. Instead of being able to take care of their needs out of after-tax income, families became more and more dependent on the state. In some of the richest countries on earth such as Sweden, and even with both spouses working, many average families could not meet their own needs for basic health and child care. With ever-higher tax rates, the poverty and dependency traps which arise when people try to move from welfare to work grew worse.

Thirdly, it finally struck me that the basic flaw in state welfare is the same one that brought socialist economies to their knees. It is simply impossible for any central welfare bureaucracy to know enough about the myriad circumstances of individuals and families to get detailed plans right. It can never acquire enough information and devise the right incentives. It cannot know whether it is dealing with a layabout or a genuine victim of misfortune. Its efforts to intervene are, of necessity, standardised, impersonal and bound by rules, whereas each case is personal and requires individual discretion. That is why for every rort we read about there is another story of a desperate situation that someone overlooked or ignored.

We surely know by now what not to do. We surely know that if we pay Jake Heke almost as much to stay on the dole as to work we will get more 'Once Were Warriors' situations. If we make the DPB sufficiently attractive, we should not be surprised that the aim of many girls leaving school in this town has been to get on it as soon as possible. Are these the outcomes that the architects of the welfare state really wanted? Are they better than those in Asian countries that have primarily relied on welfare without the state? The debate is not between those who care about social justice and those who don't. It is between those who are content to operate at the level of rhetoric and ideology and those who are interested in what works.

Recently I commissioned a study to find out why members of the average family in New Zealand today feel no better off than they did thirty years ago. It found their instincts were correct. The average worker with a dependent wife and two children has received an increase in real income *before tax* over that period of 20 percent, but after tax and net of cash benefits the outcome is a slight *reduction* in real income.

In other words, all the per capita gains of thirty years of economic growth have gone to the government, and in this time government expenditure has gone from 25 percent to around 40 percent of GDP.

Has this massive increase in mandatory payments by the average taxpayer improved society? I don't think so. In the early 1960s when I was studying economics at university, New Zealand was one of the top countries in per capita income terms. We had little unemployment, few single parents and few other social problems. It was a much more caring society.

It seems clear to me that pouring all the average person's gains in income into the state for the last thirty years has done nothing to improve society. A host of social statistics are worse than they were. Despite this, we still have some political parties and the main churches telling us that the answer is to throw more money at these problems. If you believe that after the experience of the last thirty years, you will believe anything.

In my view we should get back to a better society by restoring power to the average family to spend their own money. The state spends an average of about $33,000 per family, which is not much less than the typical family earns. How much healthier a society we would have if the average family had twice the income out of which they could take care of their education, health care and retirement. You can buy a lot of education, health care and superannuation for $33,000 a year.

In any society this would still leave the issue of what to do about those who genuinely can't look after themselves. I would guess that a generous estimate would be that one person in twenty or 5 percent of the population would fall into this category. If we spent 5 percent of GDP equally on these people they would have the average income. The other necessary functions of the state could easily be sustained for a further 5 percent of GDP. This would still leave the average family $26,000 a year in the hand to be spent on services currently provided by the state.

Just imagine what a healthy and dynamic society and economy we would have if the only tax was a GST of 10 percent or thereabouts. We could really give the Asian tiger economies a run for their money!

In addition to their internal problems, I believe welfare states everywhere are going to come under enormous international pressures in the period ahead. The 1980s seemed like a turbulent period for most New Zealanders as we started to work off a backlog of years of deferred adjustment. But the defining event of our time is the recent collapse of socialism and the worldwide move to market economies. The ripples from this event have scarcely started to spread.

Nearly 2 billion people or 40 percent of the world's population are now joining the world economy. If China continues on the rise and is joined by India, the ex-Soviet Union, East Europe and Latin America, the impact on other economies will be massive. There will be major opportunities for trade as income levels in these countries grow. But at the same time there will be enormous competitive pressures as investment pours into these countries to take advantage of labour forces that are keen to work at rates of pay well below the levels of wages and welfare benefits in Western countries. Open markets for capital and increasingly for labour will penalise countries with high tax burdens. The only way countries like New Zealand can stay ahead is to save, invest and raise productivity at high rates, and be willing to adjust rapidly to these global trends.

It follows that the idea that New Zealand is in the post-reform era and can lie back and enjoy the benefits of a decade of change is utterly naive. To sit on our hands would be to put at risk everything that has been achieved. The New Zealand economy is now far more efficient and flexible and is well placed to cope with the challenges and opportunities *provided we keep up with the pace of the frontrunners.* We learned to our cost that failure to change is a recipe for economic insecurity. Security will only come from a willingness to press on with essential reforms.

At present that willingness appears to be lacking in our political classes. Too many appear to have concluded that the outstanding challenges are too difficult and confronting the vested interests involved is too unpopular.

Most of the media have undergone a belated conversion to the reforms but are comfortable with the idea that political paralysis has now set in. They are not projecting any vision of the way forward, any more than the politicians. Outside media commentators are more perceptive and less complacent. As Paddy McGuinness observed:

> The restructuring of the New Zealand economy is far from complete - the government sectors, especially health and education, are still resisting the inevitable. The labour market is still burdened with an employment-destroying complex of Employment Court, minimum wages and open-ended benefits. ... There undoubtedly is a danger that politicians will tell the electorate that the pain is over and everyone can now relax.

The *Wall Street Journal* put it more starkly:

> Until such time as self-responsibility can be made widely palatable again, momentum for change will be difficult to maintain in New Zealand or anywhere else. Kiwi voters are going to have to come to grips with their national policy soon.

We saw what happened after 1989 when politicians opted for the last teabreak. It would be a tragedy if we were to gather here again in five or ten years' time to discover, after all that had been achieved, that 1994 was the high point of New Zealand's economic turnaround and that once again we had slid back to irresponsibility and mediocrity. The only way to avoid that fate is for people like yourselves to demand something better.

NATIONAL BUSINESS FORUM

INCOHERENT ALTERNATIVES

BOB MATTHEW
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AUCKLAND
17 MAY 1994

INCOHERENT ALTERNATIVES

If we could set aside politics, New Zealanders should today be looking to their future with more confidence than at any time in the last thirty years.

Thanks to a decade of totally mainstream economic reforms, we are now starting to achieve something like mainstream economic performance. There is a lot of momentum in the economy, and more and more people are seeing the benefits.

Graffiti like 'Whose Recovery?' are well and truly out of date. There was some point to them when archaic employment restrictions kept outsiders out of work. But since the Employment Contracts Act came in, employment numbers have grown by over 60,000 and the Reserve Bank forecasts growth of a further 70,000 in the next two years. To date the unemployed have benefited more than those in secure jobs on higher pay. While the Council of Trade Unions does not like giving priority to the unemployed, I am happy to defend this outcome. As the labour market tightens, pay rates for skills and experience will be bid up where they are in short supply, but they will not flow mindlessly across the economy through national awards. All that is exactly as it should be.

New Zealand's basic recipe for economic success is the same as virtually all the emerging countries of the world are now following. There are still a few academic socialists in New Zealand like Steve Maharey who argue for wealth *redistribution* and *state* ownership of business. But as Lee Kuan Yew recently pointed out on Ian Fraser's programme, economic progress is primarily about wealth *creation*, driven by *private* enterprise.

The success of the high-performing Asian economies is one of the two defining economic events of recent years. The other is the collapse of the communist economies which had pushed state intervention and redistribution of wealth to the limits.

Ironically, not only did countries like China end up far poorer than market economies like Taiwan, but with a far less even distribution of income as well. This outcome is not due to state welfare but to sound fundamental policies and a modest government role - if you like, welfare without the state. The hard evidence of East Asian success in achieving growth with equity ought to impress all but the most blinkered ideologue.

As Malcolm Forbes, the editor of *Forbes* magazine, recently put it, there is no mystery about the basic principles of economic progress:

> They involve sound money, low taxes, property rights, making it easy for businesses to be set up, and, once they are, not harassing them with excessive regulation and bureaucratic interference. And, of course, free trade.

In general outline, these are the lessons of East Asian economic success, and the foundations of New Zealand's turnaround.

These lessons are a source of huge frustration to those who have spent the last ten years lambasting New Zealand's economic reform programme. One such critic, Brian Easton, recently announced that "there is not yet a coherent alternative." It is nice of him to let us know he has now reached that conclusion, but he might have spared us his countless sniping articles.

However, there are still plenty of incoherent alternatives on offer. And here, regrettably, is where politics comes in. I began by saying New Zealand's future would be bright if politics could be set aside. But it can't. Anyone who believes we are out of the woods and set on some primrose path to sunny economic uplands is totally naive. There will be nasty surprises ahead, bad economic news and many setbacks. That is the reality of economic life. And any faltering of political nerve or false moves would quickly trigger a loss of confidence and a loss of economic momentum.

As a spokesperson for the Business Roundtable, there is no pleasure in having to revert to a Cassandra role. We spent three years in that role from the beginning of 1988 when David Lange and David Caygill were telling the country that the economy was like a brand new motor car just waiting at the traffic lights. We maintained that the government had forgotten to switch the labour market engine on, that the vehicle was overloaded with government expenditure, and that the car's owners no longer had any sense of direction. Unhappily we were right: the driver took a teabreak, the engine stalled, and efforts to get it going again with fiscal fuel nearly landed us in the ditch by the end of 1990.

Well, you might say, the economy is now firing strongly on all cylinders, so why the concern? The answer is that there is no immediate danger but the warning lights are already flashing a couple of years down the road, if not sooner. The government is doing very little to tune the vehicle up further, and opposition parties seem bent on sabotaging it to varying degrees. It is easy to see us ending up with the engine stalled once more.

I have to tell you that investors are starting to view New Zealand again with some wariness. A major investment banking firm brought a group of high-powered international investors to the country last month. In a letter to the Business Roundtable, they reported:

> The general feedback we received from investors was one of caution when viewing New Zealand due to some of the key components of policy (i.e. 0-2 percent inflation and the Employment Contracts Act) being perceived to be at risk in the new political environment.

Similarly Standard and Poor's have been more cautious than Moody's in reviewing New Zealand's credit rating. And the sharemarket, which takes a forward view of events, is already behaving as though it senses all is not well on the political front.

There is no question that the big threat is now politics, not economic directions or business responses. While most of the rest of the country is working far more productively, the government has gone on an extended 'go slow.' Six months ago, ministers were saying that the government had a window of opportunity at least for the first half of its term. So far the only minister to be seen leaping through windows was the minister of education, and regrettably that was not to advance some badly needed education reforms. There have been no privatisations, no initiatives on producer board reform, no moves to introduce competitive accident insurance, no external review of the Fire Service, no efforts to deal with the job-destroying madness coming out of the Employment Court, no signals as to whether the government will back the recommendations of the independent members of the Todd task force.

To be fair, Bill Birch has been working hard to hold the fiscal line, the government deserves credit for proceeding with the Fiscal Responsibility Bill, and Maurice Williamson has been trying to avoid a sell-out on coastal shipping. Let's hope there are other initiatives on the way, but the present reality is that we have seen no new ones of any consequence since the election. If the government's first shots in this term are its best shots, there is not a lot to look forward to.

What is equally perturbing is that despite the good economic news all around us, the government has still not captured the high ground in the economic debate.

Over the last few years we have had a litany of criticism of the current policy framework. Remember the complaints: there would be no economic recovery under present policies; the obsession with low inflation would mean no growth; monetary policy would cause a credit crunch; the recovery would be a jobless one; the labour reforms would push down wages; privatisation would push up prices; overseas investment would dry up unless we introduced draconian business laws; business was not paying its fair share of the tax - and so forth. All of these criticisms were nonsense at the time, as is now patently obvious.

Yet the government still seems to be on the back foot. When did you last hear the minister for state-owned enterprises documenting the benefits from privatisation? When has the minister of labour systematically taken apart the collectivist humbug from the ILO on the Employment Contracts Act? Despite having the arguments and the evidence on its side, the government is still letting its critics have a free hit. It badly needs a Brian Lara to tell it how to get on the front foot and score runs.

On the other side of politics, there is also plenty to worry investors, and hence the whole community. Labour went into the last election supporting most elements of the current economic framework. In particular, it supported the Reserve Bank Act, limited itself to specific modest spending proposals and promised no increase in taxes. After the election it said its proposal to repeal the Employment Contracts Act was a mistake; only some amendments were necessary.

There are still economically literate and responsible people in Labour's ranks. However, in the space of a few short months, Labour has talked about widening the Reserve Bank's inflation target, despite the fact that the Bank has not encountered difficulties with the present range and that eleven OECD countries now have inflation under 2 percent. It has argued for increasing spending well beyond its election commitments, and proposed tax increases. Labour's current policy is once again to repeal the Employment Contracts Act : "We think that's what the CTU would want," Steve Maharey has said. We seem to be back to the days when the unions said "jump" and the Labour Party asked "how high?"

The Alliance economic programme is certainly an alternative, but a totally incoherent one. It includes a managed exchange rate, import protection, a soft monetary policy, higher spending and taxing and a re-regulated labour market. These are precisely the policies that brought us to the verge of an economic crisis ten years ago. Yet as Rufus Dawe recently put it:

> ... instead of laughing the Alliance 'budget' out of court, as would happen in any economically literate country, the media treat avuncular Jim Anderton with undeserved respect as our most popular politician, just as they did Sir Robert Muldoon.

Pollsters tell me they believe support for the Alliance is very soft, but unless New Zealanders are clearly told about the dangers of such an economic programme, they risk ending up with it. The idea of reverting to fortress New Zealand policies at a time when the rest of the world is removing trade barriers and signing up to the Uruguay Round is sheer lunacy. The substance of the Alliance's programme needs to be debated and exposed. To date, only Michael Cullen has done this at all well.

For its part, as Rufus Dawe noted, New Zealand First has abandoned any attempt to come up with a coherent economic programme. Populism rules.

What does not seem to be on offer, apart from a few politicians within existing parties and the new one being canvassed by Sir Roger Douglas if it materialises, is a programme which would build on the progress that has been made and raise our sights much higher. The debate in New Zealand about what makes for genuine well-being and security is still set in quite mistaken terms.

For example, many in the intoning classes continue to equate caring and compassion only with spending taxpayers' money. There are already calls to ease up on spending restraint rather than run surpluses and repay debt. These come from people who presumably fail to realise that going any distance down that path would simply mean higher interest rates, lower investment, fewer jobs and higher taxes in the future - all of which would in practice aggravate the social problems they profess to care about.

I could not help thinking of the contrast between the New Zealand view of social welfare and the Asian view when I read a recent *Wall Street Journal* editorial on Hong Kong. Entitled 'Hong Kong's Bleeding Hearts,' it began :

> One of the world's truly great welfare states released its annual budget this week. Hong Kong's new spending package was chockablock with initiatives aimed at helping the people under its care achieve more comfortable, secure lives.
>
> For instance, there was a new make-work program in the form of a corporate tax cut. Bleeding hearts from Financial Secretary Sir Hamish MacLeod on down say the idea is to leave companies more earnings to distribute to shareholders or reinvest. With businesses attracted by the idea of keeping more profits, they'll expand output and hire more workers.
>
> Governmental solicitude was evident on the supply side of the labour market as well. Some 420,000 working stiffs were dropped from Hong Kong's income-tax rolls altogether, and another one million will see their taxes chopped substantially. These people can always be hit up later in life, after they've climbed the job ladder a bit.
>
> Like any good members of the breed, Hong Kong's welfare engineers wouldn't let a budget go by without trying to meet some 'unmet needs.' That phrase is fashionable among Western liberals with big tax-and-spend plans to promote. In Hong Kong's case, the budget proposes a new welfare program for the elderly. It's a tax cut too, this one aimed at families with one or more grandparents to support.

The *Wall Street Journal* went on to note that in Hong Kong, work and family are promoted as the real guarantors of social welfare. In the United States, it said, the notion that the best welfare policy might be one that lightens the burden of government is derided as 'trickle down' economics. Welfare is what comes to people in the form of government programmes and the dole. The editorial concluded by noting that the universal complaint about the Hong Kong budget, including from the pro-Beijing faction, was that taxes weren't cut enough!

By my rough calculations, using government expenditure as a measure of the true tax burden, Tax Freedom Day in New Zealand arrived this week. That is the day, more than one third of the way into the year, when most New Zealanders stop working for the government and start working for themselves. The average person in Hong Kong has already been doing so for two months. A recent Business Roundtable report highlighted the size of the deadweight costs of taxation that New Zealand is incurring. To get them down, the priority must be to repay debt and let the private sector grow faster than the public sector. We have a long way to go to match the economic prospects of Asia, a point that only Roger Douglas, John Luxton and a few others seem to realise.

What I have been saying is that, despite the progress we have made, there is a high probability, because of politics, that the economy will go off the boil as we approach the next election. If policy changes start to become likely, let alone certain, it is inevitable that business will become more cautious about plans for investment and for hiring new labour. To put investors' funds at risk by doing otherwise would be totally irresponsible.

What is not inevitable is the prospect of a slowdown turning into another recession. That possibility will depend on the stance of all the political parties. Will the government remember the message from the Clinton bumper stickers, "It's the economy, stupid," and press on with measures to strengthen the recovery? Will the opposition parties drop plans which would so obviously damage the economy and cost investment and jobs? The approach to MMP will be a testing time for responsible political leadership.

If New Zealand as a country is to decide that it wants to avoid these risks and lift its game further, it will be up to people like yourselves. The Business Roundtable is only one voice with a more ambitious vision for New Zealand: there needs to be many more. As National Party supporters, you have an obligation to decide whether, as Douglas Myers put it recently, you are happy for the government to be "just resting and thinking and humming to itself" or whether parliamentarians should be earning their pay.

More generally, you are members of the community which will ultimately decide where New Zealand goes. It is no use sitting back and blaming politicians and 'Wellington'. That has been the downfall of countries down the ages. I read in a book about the Czar Nicholas II that "the Russian people tended to accept responsibility for nothing, blaming their own sins and their country's failings exclusively on the empire's rulers." Just look where that habit landed them, and where it landed us in the Muldoon era. If you don't want to see New Zealand revert to incoherent alternative policies, it's your responsibility, as economically literate people, to make your views known. It's no excuse to say, as some of my friends do, that they don't have access to the right kind of soapbox. That's rubbish. Raise issues in the organisations you belong to, write a letter to the editor, or pick up a phone. Pam is waiting for your call.

My case to you is that we must all work a good deal harder to forge a wider and stronger consensus for successful policies. We need a much deeper community understanding of our problems and opportunities if we are to find high quality solutions. Consensus is an over-worked term, but I have no problem with the right kind of consensus. The wrong kind of consensus is the one that drove the lemmings over the cliff. Nor does consensus need to be some lowest common denominator. As *The Times* journalist Matthew Parris recently put it:

> Lady Thatcher was one of the greatest prime ministers in our history. If there is one lesson she taught me, it is that if you chart a good course, ignore opinion polls and hold on to your compass, opinion will in the end follow.

Politics and government are ultimately about opinion. History tells us that a government that loses the high ground and loses its policy direction harms the economy and often loses political office as well. At the moment, the high ground is not occupied by those on the side of successful policies. We should do all we can to ensure that it is.

GROUP OF 100 NATIONAL CONGRESS

VISIONS FOR 2010

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

SYDNEY
2 MAY 1994

VISIONS FOR 2010

Both our countries face tough decisions if we are to survive and prosper in a world that is likely to change beyond recognition in the next 20 years. It is therefore fitting, perhaps, to open with a story about tough decisions.

I heard recently that management in Heaven were finding that too many Australians were being admitted. After a management committee meeting it was decided that only those Australians who had taken hard decisions would henceforth be allowed in. The next person to arrive at the Pearly Gates was an Australian rugby referee. Saint Peter asked him what hard decisions he had taken. He said, "I was refereeing a match between Australia and New Zealand at Eden Park. New Zealand were leading by 6 points with five minutes to go when I awarded David Campese a penalty try under the posts." Saint Peter said, "Well that sounds like a reasonably tough decision to me. I'll just go and check our records to verify it." He went back to his Almighty database and returned with some puzzlement on his brow. "I am very sorry, but we don't seem to have any record of that event." The referee replied, "That's because the game's still in progress".

The moral of this story seems to be that tough decisions may be ultimately rewarded, even though the immediate consequences of them are often rather unpalatable. That certainly has been the experience with New Zealand's economic reforms.

New Zealand has had a lot to be modest about in recent decades. The New Zealand government of the day pulled out of the federation discussions of a hundred years ago because we were then a bit richer than Australians and we suspected you were after our money. Today it is embarrassing to note that New Zealand does not make the top 20 in the league table of national per capita incomes in the Business Council's *Australia 2010* report. We are edged out by Spain. Australia's GDP per capita is 50 percent higher than ours, yet it is in 18th position, only two rungs above Spain. The main theme of my remarks will be that both our countries are still well behind the play. We have an enormous task ahead of us if we want to get back to our former position in the top 10.

As my chairman told an Australian audience last month, you used to think that we were Marxists. He agreed that we were - 50 percent Karl, 50 percent Groucho. There is still quite a lot of both Karl and Groucho about New Zealand.

For example, after much agonising, the government has recently taken the bold decision to sell a state-owned enterprise, Government Computing Services. Would you believe the state still owns New Zealand's second largest computing company? And that the decision to sell is opposed by all the opposition parties in parliament? It would be even more embarrassing to have to tell a Russian audience that the government is the largest corporate farmer in New Zealand. Collective farming is dead in that country but alive and well in ours.

The bigger picture, however, is that New Zealand has achieved, at least for the time being, an extraordinary economic turnaround. It is true that you can still find headlines like "Bishop Tells Australians of Free-Market Failings in New Zealand" - incidentally not your politician but a church spokesperson who will be part of our export trade to Australia later this year. But much more revealing of current views and changes in attitude is a recent editorial headlined "Economy Powers Ahead." This appeared in a provincial paper, *The Nelson Evening Mail*, which has scarcely had a good word to say about the economic directions of the last decade. Listing some of the positive economic news, it said:

> The good result is a vindication of government policies in sticking to its guns over labour reform, the low inflation target, and retaining constraints on spending and taxation. ... there is no doubting that the country is now strongly pulling out of a long and painful recession.

In fact, the signs of recovery were clear from late 1991, when the policies referred to were beginning to take hold. The upturn has been driven entirely by improvements in competitiveness and productivity; there has been no artificial stimulus. Inflation has been within the 0-2 percent target range since 1991 and the budget will move into surplus this year. Once the highest amongst our major trading parties, 5-year government bond rates in New Zealand are today lower than in Australia and the United Kingdom. The current account deficit is small and falling. Much of it is accounted for by capital goods imports, with private investment recently running at double digit levels. Employment is growing at an annual rate of around 3 percent. The unemployment rate has come down from 11.1 percent to 9.2 percent and is continuing to fall fast. Youth and long-term unemployment are also falling. Real GDP grew by 4.6 percent in calendar 1993 and is likely to top 5 percent some time this year. Business confidence is at its highest level for 20 years. New Zealand is starting to look like an Asian economy in a slow year.

A major academic assessment of New Zealand's economic reforms appeared in the *Australian Economic Review* late last year. It rightly concluded that the costs of the programme were higher than they should have been because it was too slow and inconsistent, with politicians in the Labour government opting for a teabreak and avoiding some of the hard decisions. Nevertheless, it judged that the changes were inevitable, and the editor, Peter Kenyon, wrote in the introduction:

> The international imperative means that there is no alternative to continuing economic liberalisation in countries like Australia and New Zealand unless the preference is for a declining relative and, ultimately, absolute standard of living for most of their population.

There is a tendency for observers of both our countries to say that New Zealand has "bitten the bullet" more than Australia, but that is not entirely true. Australia never got itself into the same economic mess as New Zealand and it has instituted many creditable economic reforms, such as financial market deregulation, on similar lines to New Zealand, and in some instances earlier.

New Zealand's economic programme is sometimes described as resting on four cornerstones:

- price stability, underpinned by the Reserve Bank Act;
- fiscal discipline;
- economic openness - the removal of barriers to trade and capital movements; and
- a flexible, decentralised labour market.

On this checklist, it could be argued that New Zealand's inflation environment looks more stable and secure than Australia's, and that our labour reforms are giving us a marked advantage in terms of productivity and reductions in unemployment. However, Australian governments in the 1980s were better fiscal managers than New Zealand's, and your welfare spending and public debt burdens are both much lower than ours. Similarly your economy is more open: you are ahead of us in reducing tariffs and you have done more to remove export controls on your primary industries and to dismantle marketing boards. So looking just at these four cornerstones, and at the record to date rather than the future outlook, one could say crudely that the score is two-all.

There are still many aspects of New Zealand's economic policy that must appear curious to outsiders. The same minister who defends single selling monopolies for primary exports also defends our monopoly TAB and opposes Australian-style competition in gambling: his portfolio could be called the minister for monopolies. Similarly we have a state monopoly accident insurance scheme whereas you were sensible enough to resist the blandishments of its architects in the 1970s and have moved progressively to more competitive forms of workers' compensation. There are commendable moves in Australia to deregulate the legal profession which have not been picked up in New Zealand. You have an assets test on state pensions whereas such a proposal in New Zealand would cause a national outcry. And so forth.

Similarly there are features of the Australian economy that are puzzling to a New Zealand observer in the 1990s - or at least revive best-forgotten memories of the way New Zealand used to be. Strange beasts called twin deficits, J-curves, accords and training levies - like dingos, wombats and kookaburras, not found anywhere else on earth - keep on appearing on your economic landscape. Your central bank seems unable to decide whether its job is to keep prices stable or whether it has several others. And there were a lot of calls for looser fiscal policy to 'kick start' your recovery whereas it is clear that tighter fiscal discipline helped kick start ours.

Clearly there are areas of microeconomic reform where Australia is now lagging well behind New Zealand. I did not realise until I read reports on the recent Industry Commission inquiry that petrol retailing is still regulated in Australia; controls were removed in 1987 in New Zealand, and there have been big improvements in price and service competition. Despite much talk and some action on port reform in Australia, a major forestry company recently reported in *The Australian Financial Review* that its costs in using Australian ports were around six times higher than in New Zealand and stevedoring costs were five times higher. The retention of a Prices Surveillance Authority with controls over products such as beer seems positively archaic; most price controls disappeared ten years ago in New Zealand and none remain today. Our taxi industry is deregulated and entry is free, subject to quality controls, whereas six-figure sums are apparently paid for taxi plates in Sydney and Melbourne.

Of course the defining feature of microeconomic reform between our two countries is New Zealand's progress in deregulating employment relations, an idea whose time simply has to come in Australia. The labour market is the engine of any modern economy, accounting as it generally does for about two thirds of the cost of everything that is produced. With as much sand in the engine as New Zealand previously had, it is no wonder that the economy only advanced by fits and starts. The Employment Contracts Act is not perfect, and our Employment Court sometimes seems bent on sabotaging it, but it has led to dramatic transformations in employer/employee attitudes and quantum leaps in labour productivity. New Zealanders now view the Australian labour regime, which ours so closely resembled, in a completely different light. Commenting on your recent wharf strike, an editorial in the Auckland newspaper *The Herald* had this to say:

> A compulsory mediator - remember those days? - found the 55 sacked workers had been given their cards without 'due process'. The Industrial Relations Commission - remember when such institutions were looked on with respectful envy? - agrees... . The practical outcome is that the Australian waterfront remains comparatively low on productivity and high on price. Loading a bulk carrier in Port Kembla, for instance, costs more than three times more than loading in Tauranga... . As 20,000 Australian coalminers walk off the job, too, a hardy strain of the sort of labour

relations once labelled the 'English disease' seems to persist across the Tasman.

Such impoverishing behaviour is now largely a thing of the past in the New Zealand private sector. The few cases of recent industrial disruption have been mainly confined to the public sector, in areas like firefighting and health services where competition remains limited, or Telecom and New Zealand Rail which are still struggling to break free from the former inefficient public sector employment practices.

But while Australia and New Zealand can learn from each other's experiences, neither is the right benchmark for the other. The top performers in today's world, and the economies that will put enormous pressures on ours if we fail to adjust, are those to the north of us. Last year's World Bank report set the record straight about the reasons for the East Asian economic miracle. Put simply, it found that it was not due to interventionist policies by governments but to the creation of sound economic fundamentals. In terms of the cornerstones I mentioned earlier, East Asian governments have generally maintained a good inflation record, strong fiscal discipline, progressively more open, export-oriented economies (including more open financial markets) and very flexible labour markets.

Both our countries have got a long way to go to achieve Asian benchmarks, jointly in respect of fiscal discipline and, particularly in Australia's case, in respect of labour market flexibility. The government share of the economy has expanded greatly in both Australia and New Zealand. OECD figures indicate general government outlays in Australia totalled 39 percent of GDP in 1993, and the figure for New Zealand is similar. In many of the fast growing Asian economies, the public sector share is about half that level.

A study which the New Zealand Business Roundtable is publishing this month shows that the marginal economic costs of the taxation needed to finance current levels of government spending in New Zealand are very high. More than anything else, it is high levels of government spending and taxation which now distinguish New Zealand from the dynamic economies of Asia. I am told that a notable feature of the recent APEC finance ministers' meeting was the number of Asian countries which talked of keeping growth of government spending below the rate of growth of GDP, and keeping the ratio of government expenditure to GDP below 20 percent. The Business Roundtable has argued for a reduction of government spending to 25-30 percent of the economy by the year 2000, a very modest goal. Part of that goal would be achieved by reductions in debt servicing; we have suggested the government should run surpluses of 2-4 percent of GDP over the next few years and repay a substantial amount of debt. *Australia 2010* points out that the core business of government in Australia - public administration and defence - represents only about 4 percent of GDP. Roger Douglas has laid out a programme for reducing government spending to under 10 percent of the New Zealand economy over 20 years, and completely eliminating income tax.

An area of microeconomic reform where both our countries are trailing far behind our Asian (and Latin American) trading partners is privatisation. *Australia 2010* indicates that public sector enterprises in Australia account for about 10 percent of national output. In the early 1980s in New Zealand they accounted for about 12 percent of GDP. I have not seen a recent figure but I would guess it would now be about half that level. By contrast, in the early 1980s public enterprises were a modest 3 percent of GDP in Asia, and many Asian countries have pursued vigorous privatisation programmes in the last decade. Without exception, sales of government enterprises in New Zealand have produced large benefits in terms of cost reductions, lower consumer prices, better service and higher returns on investment, yet progress with privatisation has now slowed to a snail's pace.

The clear evidence of Asian economic success and the reasons behind it have not yet made a strong impact on public thinking in either of our countries. In New Zealand, the battle between what you would call the economic rationalists on the one hand and the economic sentimentalists on the other still goes on. To East Asians, the very terminology of the debate is incomprehensible - the case for running an economy on free market principles is rarely questioned. One would have thought the East Asian record of minimal unemployment, rapidly rising wages, an even distribution of income, admirable education standards, low crime rates, and low rates of family break-up would impress welfare, church and education lobbies. Instead they argue for the very things - higher government spending and taxes, minimum wage laws, more state welfare, progressive education - which are not to be found in Asia but which have been the source of many of our problems. It is all a bit of a puzzle.

Australia 2010 sets out a vision which is much more in line with the dynamic Asian record. The Business Council's thinking is very close in terms of broad directions to that of our organisation. Possibly the Business Roundtable has been prepared to be more radical and more ambitious, and as a result we have probably been more controversial. For example, we would not see the *Australia 2010* goal of getting unemployment down to 5 percent as being particularly demanding. Recent economic forecasts suggest unemployment in New Zealand will be down to 7.5 percent within a couple of years and there is no economic reason why it should not be below 5 percent well before the year 2000.

You may be interested to know that the current government laid out its vision for New Zealand in a document last year entitled *Path to 2010.* It set itself a goal of achieving average economic growth of 3.5 - 5.0 percent a year over that period. However, the willingness to take the tough decisions necessary to reach our full potential has fallen away over the last couple of years.

It is important to provide a sense of perspective here. Under a headline "New Zealand Voters Drop their Bundle," *The Australian Financial Review* said:

> The New Zealand election and referendum results are a disaster for New Zealand and a setback for Australia. ... The result will further undermine economic growth. ... The ... danger is that there will be some slippage, with a weaker commitment to inflation - free growth, and that reform will stop. The transformation of New Zealand to a faster growing economy will be incomplete.

It is early days yet, but not all of those fears have been borne out. Ironically, the change in electoral arrangements to proportional representation, which was pushed largely by groups wanting to turn the clock back, looks likely instead to have the effect of locking in the economic reforms. In its recent decision to upgrade New Zealand's foreign currency debt rating to the same level as Australia, Moody's recently expressed the view that:

> ... the actual risk of a major deviation from present policies was unlikely, especially now the restructuring was finally producing tangible results. Political realignments under MMP should continue to reflect underlying support for the overall reform process.

A number of decisions taken prior to the election are still coming into effect. For example, the electricity market was fully deregulated on 1 April, tariffs are continuing to fall until 1996, and the eligibility age for national superannuation is rising to 65 in a series of steps.

Since the election, the government has sold its shareholding in Fletcher Challenge and approved a major electricity contract with Comalco. It has decided to set up the national electricity grid as a stand-alone company and appears to be proceeding with its plans to deregulate coastal shipping, which is already cheaper than in Australia. More significantly, it is proceeding with a Fiscal Responsibility Bill which will be a major discipline on fiscal policy, comparable in significance to the Reserve Bank Act, and likely to attract similar international attention. The government should be able to project significant fiscal surpluses in its budget, to proceed with some privatisations and to decide on post-1996 tariff reductions in the course of this year. So, with the exception of a politically-driven decision to introduce a youth minimum wage, there has been no backsliding, and economic reform has not come to a halt.

However, while the government probably thinks it is doing its best, New Zealand is now losing ground again relative to the benchmarks that we should be aiming for. The goal posts of economic reform are never stationary. Asian countries are continuing to deregulate, privatise, strengthen their financial positions and improve their infrastructure and their education systems. Lee Kuan Yew recently pointed out to an Australian audience that East Asians are highly competitive peoples training themselves to win life's marathons. To compete in the same marathon, Lee said that Australians, and he could have added New Zealanders:

> ... must be weaned from welfare and become self-reliant and competitive. ... There is also the problem of reform fatigue. People feel they have suffered long enough in lower standards of life for over a decade, without much results. But more reform is unavoidable to complete the restructuring of the economy, or the ordeal already endured may be wasted.

Not only are our countries failing to press on vigorously with reforms but there are constant pressures for new policies which run counter to the liberalisation progress that has been made. A case in point is business law and regulation, which is a major topic of your Congress. From a New Zealand perspective, Australia has gone totally overboard in this area. We have also taken some unfortunate steps. Corporate governance is becoming more onerous and more expensive, but not notably more successful in serving the interests of lenders and shareholders.

By far the best exposition of this analysis that I have seen is the report *Strictly Boardroom* produced by a working party chaired by Professor Fred Hilmer last year. This raises major questions about corporate governance developments in Australia. It is just as relevant to New Zealand as our lawmakers have been proud to follow Australian trends. To quote its opening words:

> At some point over the last several years the debate about what boards of directors ought do and be responsible for took a wrong turn. In almost every other area of economic life the debate has been about how various participants can improve the quality and volume of their productive contributions. ... In contrast, the debate about directors has become preoccupied with criminality, fraud, negligence and minimum standards. The worry about the rotten apple - and there have been a number - has deflected attention from the main game of wealth creation which is, in turn, the driver of new investment and job creation.

Much of the legislative mania has, of course, been driven by reactions to the events of the 1980s. These did include inexcusable lapses into criminality which deserved to be visited with the full force of the law. But in the vast majority of cases losses suffered by investors were simply the result of business incompetence or their own wishful thinking. It is totally naive to think that either incompetence or original sin can be eradicated by legislative exertions. That premise is unknown to both business schools and orthodox theology. What has been missing in New Zealand is a more cost-effective and efficient enforcement process. That was the major conclusion of an expert group that reported on securities market regulation in 1991. It advised that the highest priority should be better enforcement of existing laws, but to date the government has failed to give this area any serious attention.

Instead, New Zealand, and even more so Australia, have suffered from an explosion of lawmaking which has produced a massive increase in the costs of doing business and great uncertainty about how parts of the law will be interpreted. The Chief Justice of the Australian High Court made some colourful comments on this subject a couple of years ago. Sir Anthony Mason reminded his audience of Oscar Wilde's description of fox hunting as "the unspeakable in full pursuit of the uneatable," and went on to say:

> Wilde would have regarded our modern corporations law not only as uneatable but also as indigestible and incomprehensible.

The problem from a company perspective, as the Hilmer report cogently argues, is that directors and management become preoccupied with conformance activity - trying to follow complex rules and covering their backs - and diverted from their real task which is to create wealth for shareholders and the community. From a national point of view, increases in transactions costs, uncertain law and attenuation of the concept of limited liability reduce the attractiveness of a country as a place in which to invest and do business. In a world of open borders, capital will go to more business-friendly locations. Complex and costly laws spread a miasma across the entire business community. Among the most serious long-term effects could be the increase in risk aversion and defensive behaviour, and the diversion of our best intellects into professions which specialise in crying over commercial spilt milk. We run the risk of developing the business counterpart of a welfare mentality which assumes that victims cannot be authors of their own misfortunes, that someone must be 'accountable' for every loss, and that parties cannot be left to decide for themselves how far accountability should be pursued.

New Zealand's recent business law reform programme began in the mid-1980s with the laudable objective of simplifying and lowering the costs of our corporate law framework, but was overtaken by the 1987 crash and has been in disarray ever since. Thanks to the efforts of some of our government agencies, the Stock Exchange and the Business Roundtable, and some of our more economically literate politicians, we avoided some of the worst of the Australian legislative excesses, but nevertheless suffered collateral damage. Like you, we have ended up with highly unsatisfactory insider trading legislation, and we brought in a badly conceived statutory management law. The Business Roundtable was not convinced of the case for regulating for accounting standards along Australian lines, on the grounds that compliance with the rules would take priority over determining a 'true and fair' view, but a Financial Reporting Act was nevertheless put in place. We have so far narrowly avoided Australian-style regulation of takeovers but the Companies Act which was enacted last year was a mixed bag and overall a step backwards. Our tax reforms, the main features of which were rightly regarded as a major achievement, have recently lost their sense of direction and become arbitrary and complex, particularly in the business tax area.

Roderick Deane, chief executive of our largest company Telecom, made a speech entitled "Besieged by Duties" earlier this year in which he drew attention to the rising costs of poorly conceived business law. It was interesting that it received a wave of supportive commentary, including from senior members of the Institute of Directors which has hitherto urged on the regulatory bandwagon. I believe there is now a growing recognition that we have gone too far and need to retrace our steps. I hope our Institute of Directors will commission a report of the quality of *Strictly Boardroom* to start the process. Our regulatory agencies must be made more accountable for their performance in putting forward badly researched proposals. I would favour a shift in responsibility for business law from our Justice Department and Securities Commission to our Ministry of Commerce which has a better grasp of business and economic realities. More insights from modern law and economics scholarship need to be incorporated in business law development. Interestingly, the parliamentary opposition in New Zealand, in the form of David Caygill and Peter Dunne in particular, has been generally sound in its approach to business law and I suspect would have sympathy with many of these views.

The strategic directions for corporate governance proposed in *Australia 2010* are ones that our organisation would endorse. In particular, we would favour more regulatory impact assessment, formal consultation between government and business on corporate law issues, and voluntary codes of good corporate governance and professional practice. As an example of the benefits of private sector initiative, we believe the New Zealand Stock Exchange has greatly improved its performance in the last few years. We strongly support its emphasis on self-regulation rather than the degree of statutory regulation that is now in place in Australia. From our side of the Tasman, the Australian Stock Exchange is looking more and more like an extension of Canberra. Perhaps if transactions costs go high enough in Australia we could look forward to listings of Australian companies on the New Zealand exchange. One of the things you have lost with your uniform corporations law is the ability of a 'maverick' state to preserve rationality for all. Delaware has performed this role in the United States, maintaining a core of sensible corporate law from which other states depart only at peril of migration of their companies.

More generally, I believe that if Australia and New Zealand are to achieve their visions for the year 2010, the private sector is going to have to pick up the baton in other areas as well. It is therefore pleasing to see this Congress doing just that. There is no longer much debate in our countries about the fact that we have asked too much of the political sector and suffered from the voracious appetite of politicians for controlling people's lives. Electoral and political processes are crude mechanisms for many of the decisions we want to make. We have learned that only the private sector can create the wealth and jobs the community desires. Business is the nation in its working clothes, and it needs to assume its responsibilities. Business in New Zealand is now much more ready to stand up and be counted in support of sound economic policy. I hope my remarks today might help people in business in Australia dispose of some of the myths about New Zealand's economic reforms that are still recycled by Australian media.

Hugh Morgan of Western Mining Corporation has made what I think is a suitable closing reflection. Speaking to the National Business Summit, he said:

> The Australian business community today is committed to a vision of an Australia which, for the first time since federation, will be competitive in all its economic activities. This is a revolution in the way we think about ourselves, and historians looking back on the eighties and nineties will see this revolution as the major change of our generation.

But Mr Morgan went on to warn that:

> As we develop the thinking and structure of this vision we must not forget that an extremely influential sector of the intellectual community is irrevocably hostile to this confidence and this vision.

Simon Upton, a thoughtful member of the present cabinet in New Zealand, has recently referred to a similar challenge. As he put it, the task is to motivate and energise the hardest group of people to reach - those who just get on with bringing up their families, building their businesses or working in the community - to take an interest in national affairs.

> We have to convince these people - the real backbone of New Zealand," he said, "that not to take an interest is to leave politics to the activists, the lobbyists, the crusaders, the sticky beaks and the social engineers.

If we are prepared to persevere, resist the pressures of narrow interest groups and to take the hard decisions, we can surely realise the vision for 2010. Australia and New Zealand have started down the right path and our Asian neighbours have demonstrated that there is no great mystery about how to pursue it towards greater economic and social success. As Ted Evans, the Secretary of the Treasury in Australia, put it in another context, it is simply a matter of choice.

BRITISH NEW ZEALAND TRADE COUNCIL
AUCKLAND BRANCH

A TALE OF TWO COUNTRIES

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AUCKLAND
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A TALE OF TWO COUNTRIES

Schadenfreude is a German expression which has no direct translation into English (I am glad to say), but it has been rendered as:

> There is no more subtle pleasure in life than seeing your best friend fall off a roof.

This is a wholly deplorable concept, and one for which we - and I'm sure I speak for everyone around these tables - can have no sympathy at all.

So when considering recent events in Britain's economic history there is no sense of schadenfreude in my remarks, but I do take a valuable object lesson from them.

It is a lesson that serves to show how the remarkable turnaround in New Zealand's fortunes could still end in tears. It is a reminder that economic conditions in countries like ours tend to improve slowly and painfully, but can deteriorate with frightening speed.

In Britain, after the courageous efforts of the Thatcher government to reverse years of economic decline, the rewards began to show up around 1986 in the form of low inflation, interest rates of around 7.5 percent, annual growth rates of 4-5 percent, falling unemployment and a budget surplus.

Then, within a couple of years, the government eased up on the fight against inflation, interest rates doubled, sterling was taken into the ERM at an artificially high level, and the economy started to suffer (in the jargon of the Gulf War) serious collateral damage. Britain entered a sharp recession and unemployment climbed back from below the 6 percent mark to double digit levels.

But even as the ERM crashed, as analysts, currency brokers and speculators predicted it inevitably would, the political response was more damaging still - and herein lies the lesson for New Zealand.

In 1991 John Major's government added 17 billion pounds to the deficit in a burst of pre-election spending. But that was just the beginning. Today Britain's deficit stands at close to 50 billion sterling, and forward predictions point to only a slow decline.

The Conservative government has declared, in the sort of masterly phrase we admire so much in the British, that, while it is "instinctively the party of low taxation," it has regretfully increased the rate of taxation.

Britain is still struggling to escape from a protracted recession. Because it lost the plot in the late 1980s it has, at best, several difficult years ahead of it. But as I said at the beginning, schadenfreude is the least appropriate response for us in New Zealand.

There are disturbing signs in New Zealand that some sections of the public are starting to behave like an alcoholic twitching for another drink, and that parts of the political establishment are itching to unscrew the bottle top.

Labour, despite its pre-election promises to contain spending tightly, is talking of using additional tax revenues to increase spending by $300 million - an action that would inevitably put new pressure on interest rates, reduce the prospects of further upgrading of our credit rating, and erode our international competitiveness. The recovery would be ringbarked and higher unemployment would be the direct and inescapable result.

The government has pledged $450 million over the next three years to bail out the Crown Health Enterprises. So much for fair terms of competition with the private health sector.

It has also succumbed to pressures to institute a minimum youth wage - thereby adding another political football to the game. If there is one thing most economists agree upon, it's that minimum wages can only do harm, particularly to those with the least skills. There is nothing surer than that some opposition parties will bid up the minimum rates notwithstanding that the practical outcome is to discourage employment growth. Indeed, within weeks of the announcement of the minimum youth rate, a Labour Party politician has already signalled his intention to promote legislation which would raise the minimum youth and adult wage rates and lower the age of eligibility for the adult wage.

And you will notice that there are many community groups clamouring for more - including such absurdities as government-provided school lunches.

It's true that hardship exists in society. But surely the evidence is now all around us that the only genuine cure to poverty is sound economic fundamentals and a healthy, growing economy. Encouraging further dependence on state handouts is no solution - it simply adds to the problem.

Some schools have - admirably - begun sandwich making classes for parents, and this may well improve the provisioning of children coming to school. I am depressed, however, that there are parents in New Zealand who do not know what a sandwich is, or how to make one. Can we really blame the government for this state of affairs, let alone expect it to find the solution?

The prospect of a budget surplus over the next 12 months has revived calls for public spending that are wholly at odds with our fiscal position. We need substantial surpluses for many years to repay the debts run up by the very sections of society that are now among the loudest in their demands for more spendmg.

Thanks to a period of difficult but long overdue, indeed unavoidable, restructuring, we now have a unique opportunity to outperform our major trading partners and make up some of the ground lost over the last twenty years.

We are on the brink of an economic growth rate that governments in much of the OECD normally associate with Asian countries - albeit Asian countries during a mild recession.

We are substantially improving our economic performance at a time when many countries in the developed world are in major economic difficulties. This year's growth rate in the European Union countries may not be much better than 1 percent. Germany, which was being held out by the Labour Party as a country to follow, is under acute economic stress due to uncompetitive labour costs, a bloated welfare system and over-regulation. We are not hearing much about the so-called Rhenish model these days, or the Swedish model which has also fallen from grace.

The OECD recently ran a Forum for the Future, comprising 22 people from 15 countries meeting in Paris. The European participants were particularly gloomy about future prospects for employment with many of them seeing their unemployment rates stuck at double digit levels.

Their recommendations for job growth followed in substance the New Zealand remedy: a deregulated labour market, tighter welfare policies and industry-led training schemes.

New Zealand's unemployment rate has come down from 11 to 9 percent of the labour force and is continuing to fall.

We in New Zealand have been very familiar with economic stagnation. So much so that we are struggling to get used to our new outlook.

A headline in *The Australian* recently read: NEW ZEALAND WELCOMES 6.2 PER CENT GROWTH PREDICTION.

This wasn't strictly true. The only headline in the Sunday papers to refer to the growth prospects in any form was: ECONOMIC GOLD FAILS TO GLITTER FOR NATS.

The article in *The National Business Review* which mentioned the possibility of a growth rate above 6 percent was headlined: LITTLE EVIDENCE EXISTS FOR ECONOMIC SLOWDOWN.

It was, perhaps, the most significant economic news that this country has had for a generation and, generally speaking, the news media played it into the net. Another example comes from the stockmarket, which is an important indicator of economic health. It doubled between 1991 and the end of 1993, but for lack of media interest in the phenomenon it was one of the country's best kept secrets.

Why this should be so is a matter for conjecture, but it may be that many in the media are inclined to underplay the fact of the recovery because they do not approve of the way it has come about. Also, it has always been easier to attract attention to theories of disaster than to promises of success, but never more so than over the last three years.

Furthermore, it is the case that many New Zealanders, inside and outside the news media, have had to face a steep learning curve. For example, only three years ago my good friend and *Dominion* columnist Terry Hall was lamenting that:

> The present government and its advisors have set their hearts against time-honoured solutions of increasing import protection, monetary controls, state-funded work creation and public works schemes, and higher state spending to stimulate demand.

But over the last year or so Hall has been singing the praises of the economic recovery and the healthy sharemarket.

How often did we hear forecasts or dismal reports from the likes of BERL, Brian Easton, Byran Philpott, Auckland University and Bob Edlin? Some of the bleaker messages in recent years have been that tighter fiscal discipline would weaken the economy, that unemployment would rise to 300,000, that inflation would go up to 15 percent, that the recovery would run out of steam by last Christmas, that we would be lucky to achieve growth of 1 per cent, and so forth.

Some of those who made these gloomy predictions also condemned the Employment Contracts Act, resisted the process of opening the economy up to international competition, and argued with a sometimes stupefying intransigence that Muldoonist policies - which got us into the mess in the first place - were the ones to take us into the 21st century.

If you want the country to stay on course and ensure that the benefits of success multiply, people like yourselves will have to play a part. It's always easier to leave it to someone else, particularly when taking a stand risks being misreported, misrepresented or worse. But we have come this far because some people have been prepared to argue the case, and there is no reason why sound arguments won't prevail in future.

The National caucus in Nelson voted unanimously to give the retirement of debt priority over social spending. Those who support this position should make their support known and felt.

My Business Roundtable colleagues and I are increasingly frustrated with the 'right wing' labelling of policies and organisations like the Business Roundtable that are totally in line with mainstream international trends. We will not hesitate to challenge newspaper editors who let partisan journalists get away with such rubbish. It's high time we had either equivalent - and some might say more accurate - labels like "the left wing teacher unions", "the leftist Council of Trade Unions" and "the populist New Zealand First Party", or none at all.

The environment surrounding MMP is adding uncertainty to political life.

No-one can predict with certainty what will be the outcome. But it is my hope that the public debate will bring out clearly the basic choices we, in reality, are facing - the choice between the old New Zealand and the new.

The choice of administrations over the last decade has clearly saved New Zealand from the brink of third world status, achieved victory over inflation and the prospects of budget surpluses, with strong economic and employment growth being the reward.

The other choice - a sort of fuzzy, nostalgic populism - produced, from 1972 on, 1 percent growth, severe inflation, consistently rising unemployment and burgeoning budget deficits and debt.

In my view, the centre of the political spectrum has moved decisively away from high levels of state intervention in the economy. There is a broad consensus, comprising perhaps 70 percent of parliamentarians and the electorate, about the economic fundamentals required by a modern society. These are:

- an independent central bank charged with keeping inflation to a minimum;
- a fiscal policy that aims at budget surpluses, debt reductions and lower taxes;
- a free economy, open to international influences and opportunities;
- a labour market policy that allows the market to provide effective price signals to the workforce - and to organisations that provide training and education to the workforce; and
- a social policy that effectively targets benefits and provides an incentive to people to opt for work not welfare.

Most politicians with any experience of government accept these realities. Perhaps the most striking distinction between politicians today is not which party they belong to but whether they came in at the last election or whether they have had a few years of experience in confronting hard policy choices.

There is still a serious risk that New Zealand could revert to soft options. There is no shortage of proposals to spend taxpayers' money in good times and borrow large sums during bad times. There is always an unwillingness to tackle issues that are dominated by strong vested interests - such as superannuation, education, the delivery of health services or producer board reform.

Last year I made a visit to the hinterland of China - a trip that dramatised for me how large a market of a billion people is, and how important it will rapidly become for New Zealand in terms of exports, tourism and investment.

The shelves in city shops were full of branded products, including names like Heinz, Kraft and Nestlés. Sadly, I saw nothing originating from the New Zealand Dairy Board. However, it is impossible to say how good or bad a job they are doing in this market of such vast potential - or, indeed, in any other market - because the Board is a monopoly exporter and we only have their own evaluation of their performance.

It is possible that New Zealand is emerging from an extended adolescence. We have lived too much by the heart, as adolescents do, and not enough by the head. Like adolescents we have been naive - sometimes dangerously so - about money. We may now be on the verge of a new maturity.

In that condition I hope that we can arrive at and maintain a new conventional wisdom - that the most important thing we can do is to pay off the debt we ran up in our days of make believe economics and impractical idealism. And there would be nothing in this new approach inconsistent with your own aspirations as business people representing, in many cases, a longstanding investment commitment to New Zealand.

If there is one thing British experience - and our experience from the Muldoon years - tell us, it is that so-called "caring" policies are, in practical outcome, a fraud. John Major became party leader because of a desire in some quarters to put a "kinder, gentler" face on the Conservative government. Because of its lapse into softer monetary and fiscal policies, Britain has had to go through the wringer once more. And into the bargain the Conservative Party is massively behind in the polls.

The idea that there is anything genuinely caring about the high spending, high taxing policies favoured by some in church and welfare circles defies comprehension. It is sheer immorality to put our children's future at risk by not repaying the debts we have run up. The empty statement that "the economy is about people" - what else could it be about? - is a cliche whose time has passed. We need to get serious about what really helps people and what doesn't.

The 18th century Scottish historian Alexander Tytler said:

> A democracy cannot exist as a permanent form of government. It can only exist until a majority of voters discover they can vote themselves largesse out of the public treasury.

Only if we resist that temptation do we have a prospect of capitalising on the gains that have been made and becoming a genuinely dynamic economy.

I want to see New Zealand by the year 2000 firmly established as a productive, competitive, high employment, low debt economy, with opportunities open to all. There is no doubt that we have the means of achieving that goal. The only question is whether we have the will to avoid losing the way. If we let the opportunity pass us by, we will only have ourselves to blame.

FISCAL POLICY AND PRIVATISATION

ECONOMIC ALERT 1994 SERIES
THE ENTERPRISE NEW ZEALAND TRUST

PUBLIC VERSUS PRIVATE OWNERSHIP: A PERSPECTIVE

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NEW ZEALAND BUSINESS ROUNDTABLE

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PUBLIC VERSUS PRIVATE OWNERSHIP: A PERSPECTIVE

It is an extraordinary irony in a country such as New Zealand, where most of the voting population confess an inherent distrust of politicians, that they still believe that [politicians] are the best people to control what are known as state assets. Ownership is invisible, unless it is incompetent ownership. Privatisation does not mean these assets move out of our control. On the contrary, as consumers we have the ultimate control. Governments are hopelessly inept at running businesses, as every New Zealand government has proved. Privatisation is the only answer if New Zealanders truly wish to retain control of their national assets.

Deborah Coddington, *Turning Pain Into Gain: The Plain Person's Guide to the Transformation of New Zealand 1984-1993.*

1. INTRODUCTION

A recent article by Suzanne Smith for *Economic Alert* provided an overview of the reform of publicly-owned trading entities in New Zealand. The author regarded recent state owned enterprise (SOE) policy as being highly successful but noted that the organisation model did not solve all the problems stemming from public ownership. Corporatisation represents a half-way house to privatisation.

This article examines the debate surrounding the sale of SOEs to the private sector. It demonstrates why privatisation is required to lock in the welfare gains achieved by the corporatisation process and to ensure that further efficiency gains are forthcoming.

Privatisation policies are currently being implemented the world over. In common with the drive to reform state trading enterprises, business sales have been motivated by the realisation that politicians make poor business managers. Economists no longer accept the traditional market failure arguments for government intervention and ownership which in the post-war period provided the main rationale for the enormous growth of the state trading sector. New Zealand's privatisation programme can be viewed as part of the worldwide trend to roll back the state as the logical response to widespread government failure.

Since 1987 (when privatisations commenced in New Zealand), over $11 billion has been raised from the sale of 23 businesses and other assets. Compared to the programme implemented by the last Labour government, the number of privatisations has slowed under the present National government. This does not reflect a shortage of activities which could be sold to private interests. As at June 1994 the Crown's equity interests in SOEs and Crown entities totalled $16 billion. This accounts for 30 percent of the Crown's total assets, and is equivalent to almost 19 percent of GDP.

2. THE DEBATE ON OWNERSHIP

Recent economic analysis provides public policy makers with guidance on organisational structures and, in particular, the relationship between ownership and efficiency. The literature addresses the central question: what is the optimal organisational arrangement to achieve efficiency in economic activities? This theoretical approach, which has its origins in the study of the private firm and the public choice literature, provides a valuable tool to examine the implications of different organisational structures for economic efficiency. It has been extensively applied to analyse and reform public sector activities in New Zealand and other countries.[1]

The analysis suggests that the typical relationship between public servants and politicians means that it is difficult to achieve the level of economic efficiency in public enterprises that is found, on average and over time, in private sector organisations. The main differences in public sector agencies, compared with the private sector, are as follows:

- public servants and politicians may have a number of (potentially conflicting) objectives including profit maximisation, equity concerns and the provision of benefits to special interest groups in order to attract votes;

- the nature of management contracts and organisational structures in the public sector offer few incentives to improve internal efficiency. Instead public servants may find they benefit from growth in their organisations, which represents a waste of economic resources;

- there are no marketable shares and hence no market for corporate control. This weakens incentives on managers to perform because inferior performance is not reflected in a weak share price and a poorly managed state company cannot be taken over;

- there are few constraints on management performance arising from monitoring by holders of debt. The Crown cannot be declared bankrupt;

- public enterprises are vulnerable to pressure from interest groups. There is no clean separation between commercial and public policy objectives. The public and political outcry over the proposed increase in NZ Post's rural delivery charge illustrates this point;

- measurement of the output and quality of public sector goods and services may be difficult; and

- competition in product markets may be non-existent or constrained by statutory protection, or by the nature of the goods or services.

These factors help explain the tendency towards a poor allocation and use of resources in the public sector. While in theory it may be possible to design a set of contracts and organisational arrangements to overcome these constraints, in practice political oversight is inevitably less effective than market disciplines in encouraging superior performance.

3. PROBLEMS WITH THE SOE MODEL

For many years prior to 1984 government trading activities in general performed poorly on virtually all counts - charges to consumers, service and quality, and return on assets. The net return on assets valued at $20 billion in the 20 years to 1985/86 was effectively zero. The organisations became a major taxpayer liability and a drag on economic performance and community welfare.

The introduction of the SOE model in conjunction with a number of other reforms including market deregulation led to dramatic improvements in the performance of

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1 Discussions of public sector reforms in New Zealand can be found in Coddington (1993), Duncan and Bollard (1992) and Bollard and Buckle (1987).

state trading activities. In an exhaustive empirical study on the New Zealand state sector reforms, Duncan and Bollard (1992) found that corporatisation improved both productive and allocative efficiency. The majority of the enterprises studied by the authors achieved increased returns and increases in their net worth.

At the outset of the corporatisation process it was recognised that the SOE model had shortcomings. Theory and evidence pointed clearly to the difficulties of sustaining superior performance from state-owned businesses over the long run. Privatisation is required to lock in the gains achieved so far.

In 1992 the New Zealand Business Roundtable published a report *The Public Benefit of Private Ownership: The Case for Privatisation,* which listed the many practical problems with the SOE model that have become apparent. These include:

- instability and disruption caused to management and boards as a result of the inability of political processes to definitively resolve key strategic questions;

- friction between SOE boards and management and the government about commercial decisions;

- a growing tendency for direct political intervention in SOE decision making on non-commercial grounds;

- a tendency for some appointments to the boards of SOEs to be due more to party-political connections than to be based on proven commercial expertise;

- increasing political focus on remuneration levels in SOEs, apparently without due regard to performance requirements or the ability of the SOEs to recruit and retain high quality staff; and

- difficulties associated with the growth and diversification of SOE business activities, including the natural reluctance of the Crown to inject additional equity and increase taxpayer exposure to business risk.

Since the report was written, there have been further departures from private sector norms in the governance of SOEs. These include the limitation of director appointments to a fixed term, a desire to achieve geographical balance in board appointments and the appointment of deputy chairpersons on SOE boards. All these moves have had a political rather than a commercial motivation.

Treasury papers cited in a recent *National Business Review* article also revealed serious official concerns about the SOE model.[2] Existing arrangements continue to expose the Crown to business failures and bad decisions by SOE managers. The Treasury has argued that the government is ill-equipped to manage its investments as effectively as the private sector and has called for more privatisations.

Far from being unique to New Zealand, such weaknesses have been emphasised by organisations like the World Bank and the International Monetary Fund. They have stressed the point that ownership matters. As the World Bank has put it:

> *The performance of state owned enterprises can be improved without changing ownership, but evidence from both developed and developing countries shows that, on average, good performance has been difficult to implement and even harder to sustain.*

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2 *National Business Review,* 22 July 1994.

These problems cannot be readily fixed under continuing government ownership. They are inherent in the interplay between government ownership, political democratic processes and the government's conflicting roles. The SOE model is inherently unstable in that over time political and bureaucratic processes will tend to reassert themselves and efficiency will suffer. These findings are consistent with worldwide experience with nationalised firms.

4. THE CASE FOR PRIVATISATION

Deane (1991) noted that the dramatic gains from the SOE reform process were achieved essentially by changing the incentives and sanctions facing SOE managers. The case for privatisation arises from the desire to lock in the gains achieved by corporatisation in addition to promoting further operating and financial improvements. More specifically, privatisation enables managers to:

- focus on commercial objectives;
- resolve strategic issues;
- obtain international experience and expertise through wider shareholder ownership;
- expedite major capital expenditure decisions;
- change the organisational culture; and
- remunerate staff appropriately.

An international study conducted by Boardman and Vining (1989) lends solid empirical support to these propositions. The study found that, after controlling for a wide variety of factors, the performance of SOEs was substantially inferior to that of similar private companies.

These results are supported by more recent research undertaken by Megginson, Nash and Van Randenborgh (1994). Examination of pre- and post-sale financial and operating performance of 60 companies from 18 countries in 32 industries showed strong post-sale performance through increased sales, greater profitability, increased investment spending, and improvements in operating efficiency. The study also revealed that privatised firms often increased their work forces.

In addition to improved financial performance, privatisation can be expected to have a positive influence on overall community welfare. This was demonstrated graphically in a recent study of privatisation undertaken by the World Bank cited by Nellis (1994) on the privatisation experience of 12 firms in 4 countries. To control for other factors the study constructed an elaborate counterfactual to determine what would have happened had the enterprises not been privatised. Welfare effects were estimated in terms of the costs and benefits to the selling governments, consumers, workers and competitors. The result showed that in 11 of the12 cases studied there were net positive welfare effects to society as a result of the sale.

The benefit to the nation from sales of state-owned businesses is not limited to these gains. Freeing the government from the need to ensure that SOEs are using resources wisely should allow politicians to better focus on core public policy issues. Divestments can also facilitate the repayment of public debt. Where the provision of social services requires the use of commercial vehicles for their delivery, this can be achieved by competitive contracting. The dominance of private ownership amongst the most successful economies and the greater ability of the prosperous market economies to provide affordable social assistance illustrate the point that selling commercial enterprises can complement the pursuit of other goals.

Improved environmental outcomes are another illustration of this point. Severe environmental damage has occurred, particularly in Eastern Europe, as a result of the distorted incentives facing managers of state enterprises. These included a short-term focus which encouraged exploitation rather than stewardship of natural resources. The environment stands to benefit as managers are made more accountable and exposed to the same disciplines, including general environmental regulations, as the private sector.

5. REGULATORY AND COMPETITION ISSUES

Ownership arrangements, including shareholder and capital market monitoring, are an important influence on the incentives facing decision makers in firms but their behaviour depends equally upon the stimulus of market forces and the regulatory environment. Privatisation does not necessarily improve outcomes if, at one extreme, the regulatory environment is such as to largely inhibit competition or, at another, to artificially deprive the entity of any hope of obtaining above-average returns from its investment decisions.

The number of industries in which significant competition issues are present is very small. Some monopoly issues have arisen in relation to the networks associated with gas and electricity transmission (but not to other parts of these industries which are readily contestable), and the roading network. In most cases monopoly issues are best addressed by means other than state ownership.

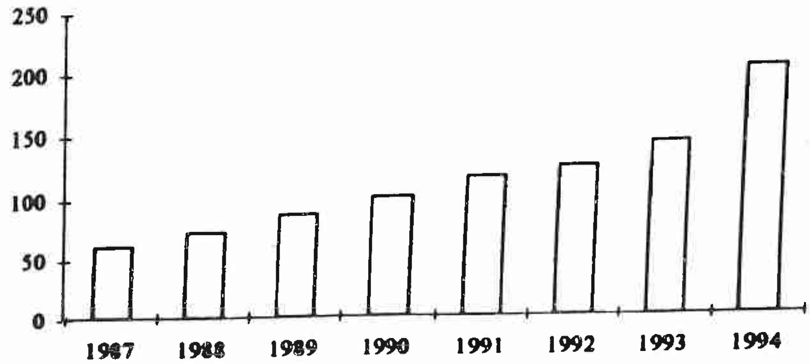
In designing a regulatory framework, the costs associated with the mechanisms must be weighed against any benefits from intervention. A relatively light-handed form of regulation has been found to be preferable. The general policy prescription is that, providing barriers to entry are liberalised, potential competition will regulate producer behaviour and provide reasonable incentives for internal and allocative efficiency.

As a corollary, it is essential in considering regulatory interventions to avoid taking a static view of the industry. Technological progress can have a dramatic impact on the ability of rivals to compete with entrenched utilities. The rapid growth of toll services and cellular phones in the telecommunications market illustrates this point.

6. CASE STUDY - THE TRANSFORMATION OF TELECOM

Telecom became an SOE in 1987 and was sold in September 1990. It is a major example of the transformation of an inefficient government department into a profitable, market-driven commercial enterprise. Formerly operated under the Post Office, it had been characterised by low productivity, poor service, deficient management information and administration systems, and was dominated by a large, government department-style, head office.

Telecom Productivity
Access Lines per Employee



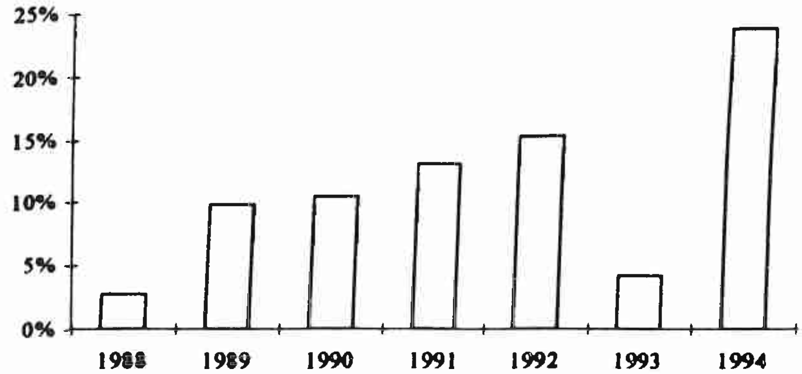
Telecom has radically restructured itself, with many of its operations now being conducted through subsidiary companies which have been given clear areas of responsibility, accountability and autonomy to meet their targets. The company implemented a major capital expenditure programme including the computerisation of outdated systems and the installation of new digital technology, and achieved large gains from contracting out services that were formerly provided internally.

Privatisation was preceded by the complete deregulation of the telecommunications market. Previously the Post Office had enjoyed a monopoly. Telecom now faces stiff competition from Clear Communications, which according to reports has captured over 12 percent of the toll market, and Bell South in the cellular telephone market. The competitive inroads made by Clear Communications and Bell South since privatisation indicate the potential for competition where a regulatory environment that avoids creating undue entry barriers has been put in place. Competition provides the best spur for efficiency and the requirement to anticipate and satisfy consumer demands.

The magnitude of the gains from the corporatisation and privatisation of Telecom and the deregulation of the communications market is indicated by the following statistics:

- a rise of nearly 240 percent in productivity over the 1987-94 period (measured in terms of number of lines per employee);
- a 660 percent rise in profits over the past six years;
- a 50 percent decline in the price of national call charges over the past five years;
- a 45 percent decline in the cost of a basket of telephone services - including line rental and national and international calls - since 1987;
- a drop in the number of party lines from 38,000 to just over 2000 in 1994;
- a reduction in the waiting times for the installation of new telephones from around 6 weeks to less than 3 days;
- directory assistance enquires answered within 20-30 seconds instead of up to 20 minutes at peak periods;
- electronic payphones are in operation 98 percent of the time instead of the previous 60-70 percent; and
- a 75 percent increase in the amount of tax paid since the company was privatised.

Telecom Profitability
Net Earnings to Average Equity



7. CONCLUDING REMARKS

The Telecom success story is not unique. International and domestic experience with privatisations demonstrate in the clearest possible terms that ownership does matter. The transfer of state assets to the private sector can generate enormous gains in productivity, product quality and profitability along with better services and lower prices for consumers.

The SOE model represents a significant improvement on its predecessor, the government department, but it is inherently flawed. Political and bureaucratic processes will tend to reassert themselves, and efficiency will suffer. These findings are consistent with worldwide experience with state-owned firms.

Privatisation is required to lock in the welfare gains achieved by the corporatisation process and to ensure that further efficiency gains are forthcoming. Furthermore, privatisations reduce the conflicts faced by governments arising from their multiple roles. Far from being in conflict with non-commercial objectives, business sales should facilitate their pursuit, above all by adding to wealth creation.

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UPPER HUTT CHAMBER OF COMMERCE

PRIVATISATION : IDEOLOGY OR PRAGMATISM?

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UPPER HUTT
14 SEPTEMBER 1994

PRIVATISATION : IDEOLOGY OR PRAGMATISM ?

The respected Australian journalist Paddy McGuinness recently commented that, having come through a decade of difficult but long overdue change, "New Zealand now confidently faces the world economy in a way it has not done in living memory."

For a long time many people felt that the pain outweighed the gain. Now that ratio has decisively swung around. Virtually every economic indicator is pointing in a positive direction and the benefits of growth are continuing to spread.

So what do we do now? Do we take time out again and go in for the mother of all teabreaks under MMP? Or do we put our minds to building on what has been achieved?

From this point on, compared to the past ten years, efforts to improve our outlook should involve mainly gain and relatively little pain. The economy is far more efficient and flexible. Most of the job losses in highly protected industries and grossly overstaffed government departments have already occurred. With net employment growth of 40-50,000 jobs a year, the smaller number of job losses that always occur in a changing economy can be more easily handled.

Do we just accept that the current economic growth rate of about 5 percent will taper off without fresh initiatives, or should we be trying to maintain and increase it? New Zealand is still an economy that is only about half as efficient and productive as the high income economies. In my view we could make at least as much progress in the next ten years as we have in the last decade in putting in place reforms which would close the gap. When the Business Roundtable makes statements like that, politicians are apt to tell us we are being "too ambitious." My question is : Why?

I am well aware from business experience that success in the commercial world involves a process of constant improvement. The demands of your customers change, new technology creates opportunities to cut costs and improve services, and your competitors are always finding better ways of doing things.

Managing a country's economic affairs is no different. Economic reform never ends for countries that aspire to the best for their citizens. If we decide once again that change should stop, we will simply stagnate or go backwards while others keep on moving ahead.

One area which offers the potential for substantial further gain with minimal pain is privatisation. On any objective test, the gains from privatisation in New Zealand are clear and ongoing. We are by no means world leaders in this area. As Dr Brent Wheeler puts it in a forthcoming book:

> Privatisation is sweeping the world. There is no doubt about it. Privatisation is not a loony idea dreamt up by the New Zealand Treasury, the far right, the Business Roundtable or Douglas-Richardson. ... there's nothing unique about New Zealand - except perhaps that we are very slow in privatising.

In my experience most people in business regard privatisation as a purely pragmatic issue. The question they ask is whether risky commercial businesses are best run by politicians in the public sector or by people with commercial skills in the private sector. Logic and a mass of evidence point to the obvious answer.

For business people, the ideological element in the debate is therefore puzzling. We have to remind ourselves that it goes back ultimately to the Marxist credo of "nationalisation of the means of production, distribution and exchange." As recently as 1977 this was reaffirmed by the Labour Party in what Sir Wallace Rowling labelled "a bloody great step backward." New Zealand never embraced official socialism, but our attachment to public enterprises has been one of the many manifestations of socialist beliefs in New Zealand in the past hundred years.

Some figures on this point are very revealing. In the early 1980s, state-owned trading enterprises were estimated to account for 12 percent of GDP in New Zealand, the same level as in Latin America. They accounted for a massive 20 percent of gross investment. At the same time, state-owned enterprises in Asia (excluding China and India) accounted for 3 percent of GDP.

At around 12 percent of GDP, the SOE sector in New Zealand was larger than the major corporate private sector. Statistics New Zealand has estimated that the fifty member companies of the Business Roundtable currently account for around 10 percent of GDP, 8 percent of gross investment and 7 percent of employment. New Zealand is not a country of large businesses. In Australia, the eighty member companies represented on the Business Council account for around 20 percent of GDP.

With privatisation, the size of the SOE sector has obviously shrunk. Statistics New Zealand estimates that it now accounts for 5 percent of GDP, 5 percent of gross investment and 2 percent of employment. Obviously it remains much larger than the public enterprise sector in Asia, however. I have not seen recent figures, but with the privatisation programmes of many Asian governments in the past ten years I would be surprised if the public enterprise sector now accounts for much more than 1 percent of their economies.

The economic policies that evolved in New Zealand from 1984 included an emphasis on:

- better resource use within the economy;
- improving the structure of the Crown balance sheet by reducing debt; and
- refocusing the government sector on its core role of providing public goods, necessary social services and a sound regulatory framework.

Within this programme, policy towards state-owned enterprises went through three main phases. The first two are well known and I shall have little to say about them.

The first involved transforming government trading departments into state-owned enterprises which were required to operate as profitable businesses. This process was vigorously opposed by the State Services Commission and the public sector unions on the grounds that the organisations were operating efficiently and there was no need to change them. The improvements in performance from the SOE programme have long since been beyond dispute.

The second step involved the opening up of SOE markets such as airlines and telecommunications to competition. This too was typically resisted by the organisations which benefited from statutory protection. However, the benefits from competition have been enormous. Commenting on Radio New Zealand's turnaround from a loss-making position to its present profitable status, its chief executive Nigel Milan recently stated:

> Without question, deregulation ... put the blowtorch of the market to the belly of all Radio New Zealand managers.

The third phase has been privatisation. Once again, many questioned whether privatisation was necessary. By the second half of the 1980s, however, the evidence was becoming increasingly clear that businesses generally perform better under private than state ownership, essentially because market disciplines create stronger incentives for performance than political oversight.

It was also becoming clear that very few, if any, government policy objectives can be well served through state ownership of businesses. By separating its policy and regulatory roles from that of an investor owning businesses, the government has been able to concentrate on its core responsibility for creating an economic environment favourable to all businesses, regardless of ownership.

The establishment of such conditions has provided a basis for successive governments to shed business and financial risk from the Crown balance sheet. This process has encompassed:

- State corporations like Air New Zealand that had well-established commercial records;

- SOEs like Telecom which had only recently been transformed from a departmental to a company structure;

- financially troubled companies like the Shipping Corporation and the Tourist Hotel Corporation which needed restructuring if they were to survive;

- assets like forest cutting rights that did not take a company form at the point of sale;

- shares in companies like the BNZ or Fletcher Challenge where the government was one among many shareholders; and

- portfolios of financial instruments as with the sale of Housing Corporation mortgages.

The range of transactions has, in practice, been very diverse, underlining the fact that looking for evidence of an ideologically-driven mass privatisation programme rather misses the point. The common element in all of these transactions has been the objective of removing risk from the Crown balance sheet and improving resource use.

The success of New Zealand's privatisation policies compared with those of some other countries reflects the fact that, on the whole, a consistent set of sound principles has been followed. The deregulation of markets which accompanied corporatisation and privatisation has forced state-owned businesses to compete with their private sector counterparts. In many instances overseas, governments have not introduced the full rigours of competition in advance of sale and as a consequence have forgone the efficiency benefits that should accompany privatisation. They have sought an inflated up-front price, ignoring the costs to the community of maintaining a protected environment for the newly privatised enterprise.

Moreover, nearly all privatisations to date in New Zealand have been relatively simple transactions involving a clean sale. By encouraging a competitive sale process, the government has sought to maximise the value received by the taxpayer. Where this rule was not observed, as in the case of the initial partial sales of the BNZ and Petrocorp, the Crown's risk was not removed and problems returned to haunt it. Similarly, warranties and indemnities are easily given but can, as the DFC experience graphically illustrated, have a very long tail.

The experience of privatisation in New Zealand has been very positive. For the businesses involved, it has:

- reduced uncertainty about strategic directions (they are no longer subject to political whims or discretion);
- allowed management to focus their efforts on achieving strictly commercial objectives (which include retaining and improving customer satisfaction);
- eliminated board appointments based on non-commercial considerations;
- reduced political interference in investment, pricing and internal remuneration decisions;
- imposed commercial disciplines such as monitoring by debt and equity holders, the threat of company takeovers to replace management teams, and the ultimate sanction of insolvency;
- removed non-commercial constraints on new capital raising and diversification (including offshore operations);
- enabled the businesses to benefit from the managerial, marketing, financial and technology resources of new owners;
- led to significant productivity gains (in addition to the initial corporatisation achievements), improved customer focus and changes in product range; and
- ensured that disputes are resolved by non-political means.

The community-wide benefits of the corporatisation and privatisation programme have made a major contribution to the present strong economic growth rates. A book could be written about them. The fact that many people are still opposed to the process suggests to me that the government has done too little to document and explain these benefits.

Three brief case studies must suffice here to illustrate the kind of changes that have occurred.

An early case of privatisation involved government irrigation schemes. These were the responsibility of the Ministry of Works and Development. It was discovered in 1986 that one of them, the Maniototo scheme, faced a cost overrun of $11.5 million at a point when it was only half completed. The government refused to continue with the initial plans. The farmers in the area that was truncated from the scheme commissioned a commercially viable alternative, shorn of the gold-plating, incompetence and bureaucracy of the Ministry. It was completed in 1990 for less than $1.5 million compared with the original estimate of $11.5 million in 1986 dollars for the completion of the scheme.

A second example of spectacular benefits is Telecom. In 1987 there were 15,000 people waiting for telephone connections; waiting periods have now been virtually eliminated. Directory assistance enquiries are answered within 20-30 seconds instead of up to 20 minutes. Toll charges have fallen on average by 55 percent and local rental charges have not gone up in real terms. A far greater range of services is available. The company's profitability has progressively improved and tax paid by the company has gone up by 75 percent since privatisation. Two major network competitors have entered the market. Members of Parliament were once plagued by complaints about telephone service; today they have all but disappeared.

My third example is electricity distribution. Corporatisation and privatisation experience in this sector is relatively recent. However, in the three years to 1993 operating costs were reduced by over 4 percent in real terms, total charges to customers fell by 3 percent and pre-tax profits rose from $28 million to $97 million. This improvement is not generally appreciated because it has been achieved at the same time as domestic subsidies were being removed, with the result that many people believe prices have actually risen. The drive for better performance is most clearly apparent in the new companies that have tradable and listed shares. There is still scope for dramatic cost reductions. However, these benefits for electricity consumers and the economy as a whole will not be realised unless the best companies are free to take over the poor performers and improve them. This requires full privatisation and tradable shares to facilitate rationalisation and provide the best return to the shareholders of the target companies.

These examples illustrate the finding that, on average and over time, the performance of privately owned businesses is superior to state-owned ones. As a World Bank paper has put it, "While private firms do not always outperform public enterprises, the evidence shows that *they usually do.*" This is not to say that privatisation eliminates all problems. Privately owned businesses can make mistakes. The essential point is that market pressures correct the mistakes much more quickly than government mistakes are corrected and the costs of the mistakes are borne by those who knowingly risked their investment - not the unwitting taxpayer.

Many objections are still raised to privatisation. Most are fallacious and should have been disposed of long ago if the facts had been properly documented and reported.

Complaints about selling the family silver, for example, are extravagant and misleading. As Brent Wheeler points out, most of it was rust. Telecom has had to pour over $4 billion into its network to bring it up to scratch. In any case taxpayers and ratepayers have received full value for sales, either through debt repayments - which mean that debt levels and interest costs are lower than they would otherwise have been - or directly in the case of share giveaways.

Similarly, claims that prices have risen are generally quite wrong. The reality is the exact opposite. The claim stems in part from a basic "socialist" argument that profits are a cost to the consumer and the need to make profits will cause prices to rise. The failure of socialism demonstrates the fallacy - forgoing profit does not mean that costs are minimised. Where some prices have gone up, this has usually been due to the removal of cross-subsidies, for example between household and business customers. But because the costs to businesses have come down, households gain overall because they benefit from the reductions in the price of business inputs into all the other goods and services they consume.

People point to all the jobs that have been lost in the former state-owned enterprises. The jobs "lost" were, of course, never really needed. The sad truth is that the people holding them were effectively highly paid welfare beneficiaries under the old system. Moreover, while additional jobs were created in these enterprises through overstaffing, we lost at least as many and more highly valued jobs elsewhere, particularly in export industries which had to purchase the overpriced goods and services.

Some people still hanker after political control of organisations which they see as producing basic goods and services. But we would never, I suggest, trust governments to supply something as essential as food - the Russians tried that and they starved. As the historian Paul Johnson has put it:

> Market democracy works much better, being a natural system of choice which allows you to vote every time you pull out your purse or wallet, instead of just once every [few] years. And manufacturers and suppliers take more note than politicians of what the public wants and usually make successful efforts to supply it. That is why, for instance, Marks & Spencer and Sainsbury's are among the most popular institutions in Britain, while parliament and government are held in contempt.

If we can set aside the ideological arguments, what possible reasons might there be for not moving ahead with privatisation? To my mind, they are hard to find. The current slowdown means we are losing opportunities relative to other countries where governments are withdrawing rapidly from business activities.

The core reasons for further privatisations remain the same: to achieve a better use of resources under private sector ownership and to remove business and fiscal risk from the Crown balance sheet. There is still a very large public enterprise sector - some 5 percent of the economy as I mentioned earlier. Why does the Crown need to own a coal mining company, a commercial cleaning firm and a heavy metal rock station? Why are local authorities putting ratepayers' money at risk by investing in forests, commercial property, ports and power companies?

Moreover, around the world, governments are moving on to the next generation of privatisations. Attention is focusing on utilities such as water and roading, and on social services such as health and education. Not even Karl Marx thought that the government had to be involved in running schools. You would have to be of a strange ideological persuasion not to be open to the idea of a larger private sector role in education.

The present is a very favourable time for the government to press ahead with moves to reduce business risk. With their major restructurings behind them and the upturn in the economy, all the SOEs are now making money. That will not always be the case. We had a reminder of business risk last month when Salomon Brothers and Price Waterhouse reported that ANL, the Australian government's shipping line, had negative assets and recommended its effective liquidation. I would not be at all surprised if one of the new power companies reported losses in the competitive electricity market that has now been created. There is no reason why taxpayers and ratepayers should be carrying these kinds of risks.

With the budget now in surplus, further divestments would accelerate the reduction of New Zealand's debt ratios to more prudent levels. By helping to reduce debt servicing costs, they would increase the latitude for tax reductions. A broader range of investment opportunities would strengthen the New Zealand equity market. Governments would be able to concentrate on their core roles.

For all these reasons, I believe there is substantial gain and little, if any, pain associated with an ongoing privatisation programme. As far as I am aware, none of our political parties has set its face categorically against further privatisation - the Alliance has said it is only opposed to the privatisation of "strategic" assets. Polls indicate that while public sentiment appears to be marginally against privatisation, it is less so than a few years ago. This could be turned around with better information. Overseas, privatisation is not a politically unpopular policy - it would not be sweeping the world if it were. Those who have a more ambitious vision for New Zealand need to present facts and arguments which will create a stronger constituency for privatisation and allow governments to get on with the job. I hope business organisations like yours will help play such a role.

NEW ZEALAND LAND TRANSPORT SYMPOSIUM '94

OPTIONS FOR THE REFORM OF ROADING IN NEW ZEALAND

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OPTIONS FOR THE REFORM OF ROADING IN NEW ZEALAND

1.0 The Importance of the Road Network

The 93,000 kilometre roading network is one of New Zealand's major assets. In the absence of any official estimate, informed observers postulate an indicative replacement cost of around $60 billion. This figure is nearly half the value of the nation's dwellings and is around 81 percent of GDP. The 11,000 kilometre state highway network was officially valued, on a depreciated replacement cost basis, at $7.4 billion in the Crown's June 1994 Financial Statement.

Total road transport-related expenditure (excluding any capital charge for the roading network) is estimated to be approximately $10 billion per annum. This is about 14 percent of total GDP, but much of this road-related expenditure represents personal consumption; the transport sector itself contributes 5 percent to GDP.

The road network is essential for personal mobility and the movement of freight. It is a critical and intrusive part of the nation's infrastructure. Contentious issues surrounding roading include recurring expenditures on grossly under-utilised roads, congestion, safety, land use and public transport issues and environmental effects, including noise, pollution, and carbon emissions.

Road design, operation, and pricing decisions have the potential to profoundly influence:

- business location decisions between suppliers, customers and ports;
- urban sprawl;
- the balance between motor vehicles, bus and rail for commuter transport and between sea, rail, road and air for inter-urban freight and passenger transport; and
- broader lifestyle and environmental choices.

An under-funded roading system could impose great inconvenience and congestion costs on society. Alternatively, an under-priced, over-expanded roading system could result in more urban sprawl, less utilisation of other transport modes and a greater reliance on motor vehicles than individuals would prefer on the basis of true costs. Conversely, an over-priced system could put undue pressure on other transport modes and under-utilise an existing major asset.

New technologies have major potential implications for the future management of the roading network. Intelligent road and vehicle systems could radically improve the quality of the services derived from the network, and affect privacy. Vehicle computers will further improve vehicle performance and limit fuel consumption. In time they could detect impaired driver abilities and/or excessive speeds and react accordingly. Global positioning systems will be useful for optimising vehicle fleet movements, route selection and curbing vehicle theft. Intelligent highways could keep vehicle computers informed concerning driving conditions, while monitoring speed and/or driving behaviour. According to *The Economist:* "The introduction of electronic toll-collecting is almost certain".[1]

While traffic densities are very low all the time on much of New Zealand's roading network, time-of-day and/or seasonal pressure will continue to build up in some parts of the system, particularly given the much higher rates of economic growth which are now in prospect.

In short, New Zealand faces a number of challenges in the coming decades if it is to maximise the opportunities arising from new technologies, environmental pressures and demand growth.

2.0 The Case for Reform

The responsibility for making sensible roading decisions falls heavily on the government since the road system is entirely owned and operated by public agencies and the government controls all the key road pricing decisions.

Given the roading network's pervasive importance, it is very concerning to find that despite many useful reforms in recent years, the current management system for public roading:

(1) fails to establish sufficiently clear lines of responsibility and accountability among the various public authorities involved with roading;

(2) is very complicated and has no well-articulated rationale;

(3) imposes conflicting objectives on Transit New Zealand (TNZ);

(4) requires TNZ to make decisions on the basis of impossibly inadequate information;

(5) seriously limits TNZ's management flexibility; and

(6) does not allow consumer preferences to be adequately revealed.

The core of the problem is the lack of a clear framework for determining the best ownership and institutional structures for the roading network.

Section 2.1 elaborates on the first two points above; section 2.2 elaborates on the remainder. A final section draws some conclusions.

2.1 Demarcation Issues

New Zealand's state highway network is currently managed and operated by TNZ, a state-owned and controlled corporate body with both commercial and non-commercial objectives. Local authorities are responsible for operating urban and rural roads, but receive from TNZ approximately half the funds they require for their construction and operation.

TNZ and territorial authorities have similar powers over roads within their jurisdictions (i.e. they both have the power to regulate road use and safety standards, and to plan, design and oversee the construction of new roads). Territorial control of local roads no doubt reflects the importance of local access considerations, whereas

1 "Big Brother is Clocking You", *The Economist*, 7 August 1993, pp 77-78.

there is a clear need, recognised in the 1930s, to have consistent standards along national highways. Nevertheless, the current separation is not necessarily optimal and may impose considerable economic costs in terms of the reduced ability to manage the roading network efficiently. To illustrate the point, the accountability of territorial authorities to the ultimate owners of these roads (i.e. tax- and rate-payers) is reduced by TNZ's power to establish and to change the designation of roads, and change the authority under whose jurisdiction these roads fall.

The power to regulate is another demarcation issue in that, while TNZ is required to advise policy makers on land transport infrastructure use and regulation, ultimate responsibility for regulating road use does not lie with TNZ. Ultimately, both TNZ and the territorial authorities are subject to control by the minister of transport, and various regulatory and enforcement authorities. For example, the Ministry of Transport is responsible for licensing drivers, setting standards for the types of motor vehicles that may be used on roads, and for regulating driving behaviour.

This division of responsibility potentially reduces the effectiveness of roading management. For example, if TNZ has no power to directly influence the type of vehicles that may be driven on roads under its control, it will not have as much incentive to consider the construction of, say, purpose-built, high speed roads. Conversely, if the Ministry of Transport cannot directly influence the type of roads that are constructed or does not bear the costs of maintaining these roads, its incentive to optimally regulate vehicle standards may be reduced.

Further, the current public road management system is extremely bureaucratic. Each year, territorial authorities must submit a district programme to a territorial authority committee. Each such committee must submit a regional programme to its regional council each year. TNZ must submit an annual land transport programme for ministerial approval. This process requires extensive coordination and consultation between the diverse public authorities and may not be the most efficient system for managing the road network.

Finally, inadequate consideration appears to be given to the incentives for TNZ or local authorities to make commercially sensible decisions in relation to the roading network. Instead, the empowering legislation concentrates on the *processes* for making decisions, and this reduces the flexibility for responding to changing demands on the road network.

2.2 *Conflicting Objectives for TNZ*

TNZ's primary objective, as defined in the Transit New Zealand Act 1989, is to:

> ... promote policies and allocate resources to achieve a safe and efficient land transport system that maximises national economic and social benefits.

This primary objective encompasses a number of different and potentially irreconcilable objectives. For example, how is Transit to determine how much safety maximises economic and social benefits? The simultaneous achievement of all of these objectives is neither straightforward nor guaranteed to be feasible in practice.

The following three subsections elaborate on the difficulties arising from the primary objective.

Achieving a safe land transport system

The safest road system is unlikely to be the most efficient. Safety is a relative, not absolute, characteristic of a transport system. TNZ cannot achieve a safe system in any absolute sense.[2] All it can do is to attempt to make it more or less safe.

Safety is just one of a number of road characteristics that motorists desire. Car buyers trade safety features for price. Motorists may offset safer roads and vehicles by driving faster in order to reduce travelling time.

The primary objective statement does not assist TNZ, or any other party, to determine whether or not it is optimising the trade off between safety and efficiency.

TNZ does not have an accurate measure of consumers' willingness to pay for road safety.[3] Therefore it cannot accurately judge whether a marginal dollar spent on making a road safer actually enhances economic welfare. A safer road or vehicle may allow drivers to save time by increasing their average driving speed, possibly at a lower accident rate. But this only improves economic welfare if the value placed on these benefits exceeds the costs. In a commercial environment, willingness to pay for the safety enhancement would dictate the outcome. Currently, consumer preferences cannot be so readily revealed.

Nor does TNZ have sole responsibility for determining how best to provide for safety. This is a matter of road and vehicle design, road use rules such as speed limits, driver education, licensing and testing requirements, and enforcement. Finding the optimal combination of measures is complex enough without the added difficulties of having to coordinate the identification and implementation of that optimum across diverse organisations which could themselves have conflicting objectives and incentives.[4]

Achieving an efficient transport system

In our view, efficiency is the single most desirable characteristic which society should seek from a transport system. An efficient land transport system would allow diverse consumer wants to be met at least cost. If efficiency were the sole goal, the most efficient system would have a set of safety attributes which would not necessarily be

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2 As the Ministry of Transport's July 1994 publication on *Land Transport Strategies and Network Funding* notes in paragraph 3.8, it is impossible even to design standards to achieve zero risk.

3 Road user surveys are at best an imperfect and potentially biased source of this information, given that respondents are likely to overweight the value of safety if they realise that, ultimately, the costs of providing safer roads will be spread diffusely across tax- and rate-payers, rather than borne directly by themselves.

4 A study of the sources of differences in road fatalities across counties in the United States found strong support for the so-called offset hypothesis that motorists drive faster if they feel safer. Safety devices in cars are ineffective in reducing fatalities as are speed limits in rural areas. On the other hand, speed limits in urban areas, and more frequent licence testing and renewal requirements, reduce fatalities. Better educated drivers (e.g. those with a college education) are safer. The study found that the higher the region's average per capita alcohol consumption the greater the expected fatality rate, but the effect is often not statistically significant. Other things being equal, more densely populated areas have a lower fatality rate. (Theodore Keeler, "Highway Safety, Economic Behaviour and Driving Environment", *American Economic Review*, Vol 84, No 3, June 1994, pages 684-693.

the same as those which are evolving under the current system of multiple objectives with diverse accountabilities.

The current system is of concern from an efficiency perspective. Political control of pricing and investment funding decisions is likely to be inimical to efficiency since politicians are subject to multiple and conflicting objectives and do not necessarily bear the full costs of any decisions. As long as they expect others to be forced to share in the cost, interest groups will lobby politicians for particular road decisions even when the expected benefits are much lower than the expected cost. Politicians are potentially vulnerable to such pressures. Such problems are likely to be greater the less emphasis is placed on a user-pays policy in respect of the particular enhancement sought.

Nevertheless, within its constraints, the current system has a number of strengths in limiting the scope for *ad hoc* political interference in the ranking of projects. Once the bases for evaluating projects have been approved by TNZ's politically appointed board (e.g. the value to be put on time and lives), the process of ranking projects according to TNZ's project evaluation manual is essentially technical. Political pressure on TNZ to proceed with uneconomic projects is further deflected since regional authorities have the right to fund local roads not funded by TNZ.

However, the constraints on the existing system merit scrutiny. Particular potential concerns, from an efficiency perspective, include:

- TNZ's inability to relate revenue to consumer willingness to pay. For example, if TNZ levels and straightens a road so as to improve safety and reduce travel time and costs, petrol excise revenue will fall. A fall in revenue from improved roading services represents a perverse incentive from a commercial perspective and illustrates the limitations of the excise tax as a device for revealing consumer preferences;

- the failure to fund all projects which pass the benefit to cost ratio test. TNZ has been only able to able to undertake projects with a benefit to cost ratio of around 5:1 in recent years. Such a wide margin implies that either policy makers do not have much faith in the information provided by the ratio test, or that viable projects are not being undertaken that would have been undertaken if roading were being managed within a different institutional structure; and

- the possibility that political pressures in respect of congested roads and self-serving resistance to user-pays induce TNZ to increase the capacity of a congested road when introducing a peak hour charge might be more efficient. Motorists might prefer to have lower roading costs from smaller capacity roads in conjunction with peak-time pricing - but political lobbying to thwart the implementation of peak-time pricing and/or the imposition of capital charges could thwart the achievement of this efficient outcome. In this way, road management by a politically-controlled organisation such as TNZ may reduce the ability of management to achieve its efficiency objective.

Given information and other limitations, it is also possible that maintenance standards set for existing roads may be sub-optimal. If so, this inefficiency could potentially distort those investment decisions which involve a trade-off between initial capital outlays and subsequent annual maintenance.

Maximising national economic and social benefits

TNZ essentially faces an impossible task in maximising national economic and social benefits. Efficiency in a commercial environment is a matter of balancing revealed and assessed willingness to pay against cost. This is far from easy. But the task of making decisions with a view to maximising national economic benefits is far more daunting. It requires TNZ to assure itself that the tangible and intangible gains from any decision it makes outweigh any losses in aggregate and will produce a more desirable income distribution. In principle, this objective requires TNZ to:

- have sufficient information and incentives to assess accurately enough the economic impact of road management decisions on all individuals taking into account any effects on property values, migration flows, job prospects and the broader environment - when those same individuals have good reasons to conceal the true impacts;

- choose the particular configuration for the roading network that maximises aggregate net benefits for society, and reallocate resources to achieve this configuration; and

- resolve conflicts between gainers and losers and ensure that adequate compensation is received by any individuals adversely affected by its decisions - even though it is not necessarily funded by those who benefit.

To illustrate the last point, consider the case made by tourist operators that better roads to remote tourist locations benefit New Zealand by attracting more tourists. Unless the losers are compensated by the gainers, TNZ cannot objectively determine that the nation is better off. However, TNZ cannot charge tourist operators generally for this alleged benefit, but existing road users must pay.

Social objectives presumably incorporate the issue of assessing whether or not one income distribution is better than another. Currently, social objectives in respect of the provision of roads are not clearly articulated, nor are the costs of meeting those objectives carefully documented. Transit arguably faces a near-impossible task in determining the ultimate effects of any of its decisions on the distribution of national income. Having formed a judgment on this, it would then be required to decide which distribution maximises national welfare. In reality, this subjective exercise can only be determined by the government of the day. This raises a number of doubts regarding:

- whether the objectives can be successfully described and communicated to TNZ in a manner that facilitates their achievement;

- whether manipulation of roading infrastructure is the best instrument for achieving social policy objectives; and

- the inconsistency between the (short) average life of social objectives (often linked to the political term) and the (long) economic life and lead time for construction of roads.

2.3 *Concluding Comments*

The current institutional structure for operating the roading infrastructure is notable for its lack of a well-specified overriding objective. If this objective were known, the problem of how to trade off subsidiary objectives or constraints would be clarified. Plausibly, TNZ may have acquired statutory monopoly powers over the roading network because policy makers perceived roads to be a natural monopoly but, if so, it is not obvious that the existing institutional structure surrounding TNZ is optimal.

In order to meet potentially irreconcilable safety, efficiency, economic and social objectives, TNZ must trade off at least some of these various objectives, but it has no clear guidelines for making these trade-offs optimally. The confusion created by a number of different and potentially irreconcilable objectives potentially impairs the management function and focus, diverting costly resources into non-productive areas.

The lack of focus may also make it more difficult for TNZ to make tough management decisions. For similar reasons, monitoring agencies are unlikely to have sufficient information to be able to evaluate the efficiency of the organisation.

In considering any reforms, careful consideration needs to be given to the feasibility of TNZ acquiring the information it requires to meet its objectives. The benefit-cost ratio approach taken by TNZ in making investment decisions demonstrates that much of the information that private firms would employ in making a similar decision (e.g. projected earnings from the new asset based on revealed willingness to pay by consumers) is not available under existing public management of the roading network.

Due to current legislative barriers to entry and funding arrangements that would penalise potential private entrants to the roading industry, TNZ is protected from competition. This is likely to further reduce the incentives for TNZ to manage the roading network in an efficient manner.

For these reasons, savings might be available from greater clarity in management objectives, clearer demarcation of powers over the roading network, a more decentralised and less rigid planning process, and the removal of legislative and funding barriers to entry to the roading market.

Such an analysis motivates the case for reform, but does not attempt to prove that reforms are desirable. That requires demonstrating that an alternative approach would improve the situation. The criterion to be used in comparing alternative arrangements is often critical to the choice. The criterion of economic efficiency is considered in the next section.

3.0 Criteria for Reform

Efficiency is about best meeting consumer preferences at least cost. When users are confronted with the costs of their actions, their choices will reflect a balancing of benefits and costs. If prices reflect all costs and those costs have been minimised, for example because producers have been driven to trim costs and price competitively, then the chances are good that outcomes will be efficient. Most of the institutional reforms in New Zealand in recent years have been driven by this approach.

The CS First Boston report for the New Zealand Business Roundtable considered the case for more fundamental reforms to roading than have been implemented to date. We reviewed the current system of roading management from an efficiency perspective, using similar efficiency criteria to those used in the other public sector reforms. The incentives on current managers to identify consumer preferences and meet them at least cost are important, but so too are the constraints which could thwart their attempts to achieve such a goal. Questions of clarity of objectives and accountability, ability to obtain the necessary information and the extent of delegated authority to make capital asset, personnel and pricing decisions are all relevant.

As the SOE reforms have demonstrated, considerable efficiency gains can be derived and accountability much improved from assigning a single, overriding objective to any given entity. Typically governments have multiple objectives; they need to have an institutional framework which will help achieve the best policy, purchasing, production, funding and/or income distribution outcomes. Hence the optimal institutional structure may require a number of distinct entities, each with one overriding objective.

In the case of roading, the situation differs from that applying to all the SOEs in that revenue is derived from taxing a necessary roading input (petrol) and applying a form of charge to heavy vehicles rather than by charging directly for the services (safety, road quality, route convenience etc.) provided by TNZ. Because many road outputs are a substitute for petrol, the petrol tax is flawed as a mechanism for revealing consumer preferences. In particular, fuel taxes do not facilitate the discovery of user preferences concerning congestion, safety, surface quality and willingness to pay for fewer bends and/or hills.

Therefore reforms to the roading system must take into account the feasibility of reforms to the billing system for roads.

4.0 Reform Options

Options for improving the economic efficiency of the roading network include: a limited evolution of the status quo; the commercial operation of publicly-owned roads through a state-owned enterprise (SOE) structure; and private ownership and operation of roads. Issues of property rights, regulation (for safety and/or monopoly), billing systems and financial structure and monitoring arrangements need to be addressed.

The timing of the two latter reforms would be a matter for debate and would be subject to the gathering of further information and the development of cost-effective billing technologies. Nevertheless, given the rapid rate of technological change at present as other countries in the world move to ever more sophisticated systems for vehicle and driver identification, location and speed and safety control, New Zealand would be remiss if it were slow to consider how to best exploit these developments in order to improve the value we are deriving as a nation from our roads.

The pace of change at present is such that the prospect of far-reaching reforms for New Zealand roads is not an idle one, especially in the light of the reform of telecommunications and aviation in New Zealand and the German government's announced privatisation of its autobahn system.

We consider two options for commercialising the public road network:

- assigning ownership and commercial objectives to TNZ only for the current state highway network. The Crown would hold all shares in TNZ; and

- extending this assignment to all roads. Both the Crown and local authorities would hold shares in TNZ in proportions reflecting their relative historical contributions to the road network.

The more limited state highway option would be easier to implement in that the Crown is the dominant owner of the asset. Also, it may reduce concerns about monopoly power over the roading network, since monopoly power is a more serious problem for local roads and ownership of these roads would not have changed. One disadvantage is that it might be harder to introduce new technology (e.g. tolling systems) in a consistent fashion across the entire road network. Furthermore, it may lead to ongoing contractual problems between (non-commercial) local authorities and a (commercial) TNZ. *De facto* corporatisation of local roads may result from the funding constraints faced by local authorities, and this may occur in a less consistent fashion than if commercial operation of all roads were undertaken within one institution.

On balance, therefore, we suggest that further work should be undertaken on the more ambitious option of commercialising all roads. This option would provide greater potential economic benefits from corporatisation, given that the value of the asset affected by the reforms would be much larger than under the more limited corporatisation option. Furthermore, the evolution of the most efficient industry structure (perhaps based on separate commercial operation of roads along regional divisions) would not be precluded by this initial industry configuration. However, this approach may be harder to implement and would surely exacerbate concerns about monopoly operation of roads.

5.0 Reform Issues

Irrespective of the option adopted, the policy issues arising from a greater commercial emphasis in roading management include:

- the need to collect a greater proportion of revenue directly from road users; and

- property right and regulatory issues.

5.1 Revenue

Direct charging of road users, rather than using taxes, would be a crucial feature of both the SOE model and private operation of roads. Except as a transitional arrangement, neither the SOE nor private roading firms would have access to fuel tax revenue. The power to tax is inconsistent with competitive neutrality. Fuel taxes are a blunt charging instrument that do not facilitate the discovery of user preferences concerning such diverse roading attributes as congestion, safety and surface quality. They do not allow time of day, or route-specific pricing. One of the key features of the SOE model is that the SOE, like any private business, must charge consumers directly for their use of the SOE's product or services. In this way the SOE can find out what users really value. In contrast, assuring a SOE of tax funding would reduce its incentives to search for billing systems which would facilitate discovery of consumer preferences.

The economics of direct charging is obviously a crucial issue. Fuel taxes are very economical to collect and do not impede the flow of traffic. The New Zealand experience has highlighted the inconvenience of paying manual tolls on roads (e.g. the Auckland Harbour Bridge).

In our view, the preferred approach in commercialising roading would be to seek to exploit, when it is economic to do so, the advanced electronic billing systems currently being developed in a number of countries. This new technology, which does not impede traffic flows, represents a massive change in the constraints facing societies in respect of how they choose to run road systems.

Norway and Singapore have already implemented cordon pricing for entry into the city centre, while many others, such as Hong Kong, the Netherlands, the United Kingdom and Sweden have studied the feasibility of such action.[5]

Singapore is currently testing an electronic billing system which would bill motorists for using streets in the same way they are charged for water and electricity. A card, about the size of a credit card, is slotted into a device attached to each vehicle. When the vehicle passes beneath a pair of gantries across the road, the first gantry reads the card and the second deducts the appropriate charge from the card, or photographs the rear number plate. The charge may be based on mileage, congestion or straight access. Each vehicle card unit could cost up to S$200 (NZ$220). For Singapore's 600,000 vehicles and motorcycles, the in-vehicle cost could therefore be up to S$120m

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5 Speech by Robin Dunlop to the LGA Conference, Palmerston North, June 10-13 1994, p 1.

(NZ$133m). *The Economist* (11 June 1994) indicates that the contract to implement the system could be worth S$200m (NZ$220m).

In South Africa, Tolcon, a privately-owned company, operates 400 kilometres of highway roads. Tolcon has run a pilot project to collect tolls by means of a microwave device that reads a tag on the front windscreen of vehicles. Payment could be achieved by monthly billing. The direct capital cost of the system is around NZ$45,000 per toll lane. Each tag costs around $10. The cost of billing could amount to 2.5 - 5 percent of the toll fee. The microwave system frequency needs to be different from radio-broadcasting frequencies, perhaps near to a military frequency, and would ideally be the same frequency nationwide.

According to Keating[6], electronic tags used in the Dartford River bridge and tunnel crossing of the Thames east of London, are given free to users but £25 plus VAT is charged if lost or damaged. These tags simply allow the vehicle to be identified. How the vehicle owner is billed depends on the arrangements made when the tag was issued.

Less information is available on the cost of a billing system for an entire roading network. No doubt it would depend greatly on how sophisticated a system is envisaged and how quickly it would be brought in.

The new technologies will continue to improve and will bring benefits which extend beyond their billing system advantages. According to reports, two major car manufacturers overseas are now installing transponders simply in order to reduce assembly-line costs. Conceivably moves to adopt satellite-based tracking systems for fleet management, theft control and/or navigational purposes could increase the synergies between billing system requirements and other users in future.

From an efficiency perspective, the case for incurring the costs of a billing system must be based on the likely savings from improved expenditure decisions. Large benefits for society are likely to follow from the resulting improvement in the information upon which investment decisions are based, given the high value of the roading network and the importance of maintenance and investment decisions in managing this capital asset. Direct measurement of consumer willingness to pay for different classes of roads and safety standards would provide a valuable source of management information that is not available under the present system of road management. In contrast, roading administrators currently rely on contentious benefit-cost analyses in selecting investment projects.

In a commercial environment, decision making would be more straightforward in that road usage patterns and willingness-to-pay would be directly linked. Road enhancements would occur when road users were perceived to be willing to pay for them. Improvements in road design and surface quality would be better tailored to users' willingness to pay for such attributes as safety, speed and comfort. Information gained about how users subsequently respond to enhancements in one part of the system could then be used to assist in decision making elsewhere. Peak-time charging could facilitate the achievement of such efficiencies on the (relatively few) roads on which congestion is a problem.

Dunlop[7] has commented that toll road companies "charge between 9 (Europe) and 31 (Japan) cents/km travelled for light vehicles whereas the Land Transport Fund [in New Zealand] receives less than 1 cent/km for all traffic". In New Zealand excise

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6 Giles Keating, "For Whom the Road Tolls", *Economic Affairs*, June 1993, pp 23-25.

7 Robin Dunlop, op. cit. p 3.

duty on petrol of 30.2¢/litre probably represents a cost of 3¢/km for the average car. Giles Keating assumed a per kilometre electronic billing rate of 3p (now 8¢) for cars on motorways and trunk roads and 8p (now 21¢) in towns for the United Kingdom.[8] From an efficiency perspective, the large capital investment in the New Zealand network is now a sunk cost, and it would not be desirable to increase user charges sharply for those parts of the system which are already under-utilised.

No doubt less costly billing systems will become available and could be progressively introduced on a piecemeal basis. Nevertheless, in the event that a new billing technology was judged to be viable for the network as a whole, it would be very important that all decisions concerning implementation should be as commercially-driven as possible. In the context of an SOE model, the SOE would be responsible. In this case, we foresee a transitional period in which the SOE would be reliant on current systems of funding for road infrastructure (i.e. fuel tax) while it developed and implemented its preferred billing system. Such taxes could be phased out according to a timetable that was reasonable but pressured the SOE to develop a replacement billing system expeditiously.

5.2 *Property Right and Regulatory Issues*

Commercial operation of roading could involve a reallocation of property rights which might, in isolation, be considered socially undesirable. For example, certain rural roads may not be commercially viable if maintained to their current high standards. However, rather than regulate the roading firm to force it to maintain these roads to uneconomic standards of quality, alternative policies and instruments could be both more effective and efficient in dealing with these outcomes (e.g. targeted income support to affected road-users).

Current external regulation of road use and safety standards does not provide a basis for assessing what the optimal level and extent of safety regulation should be. Without external regulation, cost-effective voluntary monitoring and information disclosure by road users and commercial road suppliers would be more likely to supply the optimal level of road safety at least cost, provided road users and suppliers had some ability to sue the appropriate counterparty for breach of contract.

Property rights in relation to safety have the potential to critically affect outcomes. Incentives are likely to be sharpened if the road operator and/or enforcement authorities can be readily sued for failure to perform their duties adequately. An interesting discussion by Palmer[9] illustrates the potential role of property rights in affecting safety incentives. Palmer notes that a common law rule applies in New Zealand which makes a local authority not liable for any damage resulting from ordinary disrepair of a road or footpath. Furthermore, in a definitive case concerning liability for a faulty culvert, *Hocking v Attorney General*, North J stated in relation to non-feasance:

> But, subject to these exceptions, while a road authority is immune from liability to users of the highway who are injured as a result of the unsafe or dangerous state of the highway so long as it adopts a merely passive role, once it decides to reconstruct or repair a road, then it is obliged, like anyone else, to exercise reasonable care on the performance of its self-imposed task.

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8 Op. cit. p 24.

9 K. Palmer, "Local Government Law in New Zealand", Law Book Company, Auckland 1993. We are grateful to Greg Dwyer for drawing our attention to this source.

In contrast, Palmer documents that this immunity under common law for omissions of non-feasance was abolished in England in 1961.

Given well-defined legal liabilities, self-regulatory powers for road use should be immediately transferred either to TNZ operating as an SOE or to private road operators so that they can take effective measures to manage their risks.

The regulatory structure for obtaining environmental clearance for roading projects in New Zealand is governed by the Resource Management Act (RMA). Theoretically, the provisions of the RMA would apply equally to all participants in the roading industry, whether public or private. However, in practice, planning agencies are unlikely to sanction widespread duplication of existing roading infrastructure, so this is likely to leave new entrants to the roading industry in an uncompetitive position relative to the existing road network. This situation is not unique to roading and could justify a general review of the economic impact of environmental legislation rather than specific legislation targeted at roading.

Monopoly issues are likely to be a more serious problem for local roads. Monopoly power in the inter-urban highway market will be reduced by inter-modal competition (e.g. air, sea, and rail) and (depending in part on the RMA and local geographical factors) over time, by the emergence of competing rival motorways and bypasses in some locations. Opportunities for replicating local roads are clearly fewer, and only limited forms of inter-modal competition (e.g. urban rail) are available.

Monopoly power does not necessarily justify regulation of roading suppliers. While unregulated monopoly operation can impose economic costs through restricted output and higher prices, regulatory intervention may not provide benefits in excess of costs, because of the lack of information available to regulators and incentive problems created by external regulation. The choice between regulated and unregulated monopoly supply of roading services is a choice between two potentially inefficient outcomes.

The Commerce Act provides a general structure for regulating monopoly power that may be used instead of industry-specific regulation of roading. Therefore, a "wait-and-see" approach to regulation could be employed for roading. The risk that could arise from adopting this approach could be greater uncertainty regarding the extent and the quality of regulation imposed by the Commerce Commission on the roading industry. If monopoly power did emerge as a significant problem, or regulatory intervention was adopted in a piecemeal fashion under the Commerce Act, then unified roading-specific regulation might be justified. Our preliminary view is that regulation should not anticipate the emergence of these problems, but this is an issue which would have to be considered very carefully in conjunction with decisions taken in relation to the reallocation of property rights more generally.

5.3 Private Roads

Once commercial operation and the regulatory environment for roading were established, there might be no strong rationale for ongoing public ownership of roads. Internationally, there are longstanding examples of privately operated roads. Furthermore, increased private sector participation in roading is becoming more common in both developed and developing countries, although more often as a result of public sector funding constraints than for efficiency reasons. Argentina, Brazil, Mexico, the United Kingdom and Germany are looking at privatising some existing roads, or have already moved to do so. The United Kingdom intends to use shadow tolls until electronic tolling is viable.[10]

10 Robin Dunlop, op.cit. p 3.

The international evidence supports the conclusion that public sector intervention in the private operation of roading increases the risks of failure of privately-owned road infrastructure as a result of reduced commercial flexibility. The greater commercial focus of private ownership and the enhanced monitoring of roading management under private ownership suggests that, as long as monopoly costs (including the costs of regulations) are not severe, corporatisation of New Zealand roading infrastructure would provide even greater economic benefits if it ultimately led to private ownership of the roading network.

6.0 Evolution of the Status Quo

Since, in our view, the viability of electronic billing is crucial to the viability of the SOE model for TNZ, any decision that the current costs of such a system outweigh the likely benefits would turn attention to the options for reform based on separating the role of the Crown as a purchaser of roading services from its role as a provider. The difficulties here - with specifying the detailed attributes of the roading service that the Crown would purchase, trying to ensure contestability in the provision of road network services and monitoring TNZ's performance in this respect - would then have to be addressed (although these difficulties have been addressed in other areas such as the Crown Research Institutes and the Regional Health Authorities). However, this alternative 'Crown agency' model may still provide some benefits relative to the current system of road management if the costs of electronic billing are prohibitively expensive well into the future.

One possible means of ensuring some separation of commercial objectives from other political objectives under the Crown agency model would be to specify a transparent, arms-length funding arrangement. A commercial roading company, whether publicly or privately owned, could still generate revenue from its roads without adopting electronic billing if the Crown paid a 'shadow' toll to the company (i.e. a toll per vehicle using the company's infrastructure). Funds for the shadow tolls could still be provided from licence and registration fees, petrol taxes and road user charges. This approach would minimise the adjustment costs of moving to a new funding mechanism, but it would be unlikely to provide quite the same incentives or information necessary for commercial organisations to satisfy road user demands in the least cost fashion as would be provided under electronic billing.

7.0 Concluding Remarks

Many challenges lie ahead for the organisation of the New Zealand roading system. Many countries are ahead of us in terms of privatisation and the introduction of new technologies. This should not, by itself, trouble us. We do not have the congestion problems confronting many cities and we do not have a comparative advantage in the development of these technologies. We can learn from those who face more pressing problems.

Nevertheless, our current arrangements have many actual or potential deficiencies which should concern us all from a longer-term perspective. We need to be looking ahead to anticipate where we will probably need to be in the coming decades, if only to ensure that the changes we put in place in the next few years represent a sensible transition path to something better.

Our report for the New Zealand Business Roundtable provides an agenda for further research and development of reform options; it is not a definitive prescription as to which options New Zealand should adopt.

The report identifies the need to clarify objectives, improve accountability and clarify property rights, regardless of the desired end-point for the organisation of roading. The issue of how far and how fast to move and the matters of detail are very much subject to debate, clarification and evolving technological developments.

One thing that we can be certain of is that the issues discussed in this report will be with us for some time. Worldwide, private sector involvement in roading is growing apace.

PORT NICHOLSON ROTARY CLUB

WHY TAXES SHOULD NOT BE INCREASED

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

WELLINGTON
20 JULY 1994

WHY TAXES SHOULD NOT BE INCREASED

> Taxes are paid in the sweat of every man who labours. If those taxes are excessive, they are reflected in idle factories, in tax-sold farms, and in hordes of hungry people tramping streets and seeking jobs in vain.
>
> Franklin Roosevelt, 1932

It is extraordinary that the question of whether taxes should be increased is still being debated. Expenditure decisions taken in 1990 and 1991, and the strong expansion in economic activity since that time, have greatly improved the country's fiscal outlook. Last month's budget forecasted operating surpluses - broadly comparable to a company's net profit - of $1.3 billion this year, rising to $5.0 billion by 1996/97. To prevent surpluses growing to unjustifiable levels, the government has foreshadowed tax reductions.

Despite this radically changed outlook, the Vicar of St Peter's Church in Wellington, Rev David Tannock, is one who responded to the budget as though nothing had happened and repeated the call for higher taxes:

> ... the government should consider an income tax surcharge for the top 25 percent of income earners. That surcharge, which could be progressive toward the top end of the scale, should be calculated on the basis of providing all households with an income sufficient to allow a decent level of participation in society.

The vicar argued that his proposal would have two advantages:

> It would address the growing disparity between the very rich and the very poor without increasing the overall level of debt;

and:

> Most of those in top management positions in the economy are in the high income bracket. The surcharge ... would provide a clear incentive for an acceptable combination of good economic performance and social responsibility.

The vicar is not a lone voice. The social justice paper published by the church leaders in 1993 advocated a massive increase in government expenditure and therefore higher taxes. Welfare groups and commentators such as Brian Easton and Bryan Philpott have made similar calls.

In the light of these views, I want to put the case for not increasing taxes now or in the foreseeable future.

Taxes are the most significant government intervention in most economies simply because of the growth of government in recent decades. The primary purpose of taxation is to fund government spending. In the current fiscal year (1994/95) total central government expenditure (generally accepted accounting practice basis) is expected to be about $31 billion or 34.7 percent of GDP. Local government expenditure could account for another 3.5 percent of GDP. Figures on spending by other public agencies, such as the fire service and ACC, are not readily available. We can be confident, however, that total government expenditure will be at least 38 percent of GDP or about $29,000 per household. Average private spending by households, partly funded by government income support, might reach $34,000 in 1994/95. *The government is planning to spend 85 cents or more for each dollar that will be spent by the average household.*

The advocates of higher taxes rarely explain why the government cannot carry out its proper role, including the provision of an adequate safety net for people in genuine need, within its present budget. They argue that unmet needs should be addressed by new expenditure and higher taxes. However, taxes reduce the ability of people to take care of their own needs. Similar arguments contributed to the large rise in central government expenditure from around 22-25 percent of GDP in the twenty-five years from 1950 to a recent peak of over 40 percent. This growth has not stopped the apparently endless calls for more government expenditure.

The New Zealand Business Roundtable has examined central and local government spending in many reports and submissions. Our unequivocal conclusion is that the government has strayed well outside its core business. It engages in numerous activities that would be better undertaken by the private sector. In the social area, many programmes create poor incentives, for example by discouraging paid employment, and high levels of subsidisation of tertiary education unambiguously provide welfare for the relatively wealthy as the Todd report concluded.

The costs of legitimate government activities could be substantially reduced by encouraging competition for the supply of services and by making greater use of user charges. User charges are normally very different from taxes in their effects. They provide information to suppliers on the quantity and quality of services which consumers are willing to buy, permit a wider range of services to develop to meet consumer needs and avoid the economic costs associated with mandatory taxes. We could use taxes to pay for food, but we don't because all those advantages would be lost. People can generally make better decisions on how to meet their own needs than politicians acting on their behalf.

The disadvantages of higher taxation need to be taken into account in assessing calls for increased government expenditure. The net benefit of higher expenditure and the taxes needed to finance that spending is what is relevant for public policy. The costs of higher taxation are rarely considered by its advocates.

Rising government expenditure has been accompanied by an increasing tax take. Taxation per head (measured in 1988 dollars) increased from around $2,000 in the early 1960s to over $7,000 in 1993, an increase of more than 250 percent. Total tax revenue in 1994/95 is estimated to be $29.3 billion, some 32.9 percent of GDP, or about $24,900 a household. Local government taxes added at least a further $400 per household.

A forthcoming New Zealand study shows that for a male head of household with two children on the average wage, the entire growth in real income between 1963 and 1993, 20 percent, was eaten up in higher taxes. Real disposable incomes have been stagnant for the last 30 years for the average family. In contrast, between 1953 and 1963 a similar household had enjoyed a strong expansion in real disposable income. There is little evidence to suggest that the average householder believes that the quality and quantity of government services have improved much over the past 30 years. Is it any wonder that people are disenchanted with politicians?

While justifiable government programmes yield benefits which exceed their costs, taxes, taken by themselves, are usually bad for an economy. Because people alter their behaviour in response to taxes, they reduce output and incomes by discouraging work effort, investment and the willingness to bear risk, and they adversely affect a host of choices which people face each day.

Taxes that affect the after-tax reward from employment deter some people from participation in paid employment. For these people, income after-all-taxes (but not before-tax income) is unattractive relative to the benefit derived from alternative uses of their time, for instance care giving or leisure. How often do we hear someone say it is not worth working because the taxman takes too much? For other people, taxes may limit the amount of time that they devote to paid employment, inhibit their investment in training and education, and reduce their willingness to seek promotion.

Taxes also bias the choice between home (non-market) and market production of goods and services. In deciding whether to hire someone to paint a house or to do the job themselves, people weigh up the amount of tax-paid income that would be needed to pay the painter against the before-tax value of their time. They are not taxed on their labour when they paint their house. The tax element applies only to the purchase of services with tax-paid income and it biases the decision in favour of home production of goods and services.

People face choices every day such as whether to repair the car, modify electrical wiring, grow vegetables, mow the lawns, or engage home help. Few people complete the sums involved, but most make a judgment on how to make the best use of their time, skills and income, and taxes exert a powerful effect on their decisions. The practice of offering a lower 'cash price' for jobs is just one illustration of the influence of taxes on people's behaviour.

Taxes also encourage:

- some people and firms to migrate to countries with more attractive fiscal regimes;

- individuals and firms to incur excessive expenditure that is deductible for tax purposes. The taxman shares the cost of goods, services and capital equipment;

- firms and individuals to lobby for favourable tax treatment. Ingenious arguments are advanced with the aim of justifying special treatment. The additional cost imposed on other taxpayers is conveniently ignored; and

- firms and individuals to avoid and evade taxes.

The incentive effects of taxes are critical to understanding why taxes discourage economic growth. Their impact is determined by the effective marginal rate of tax. This is the government's overall share of an additional dollar of income. It reflects the statutory rate of tax, the effect of additional income on entitlements to welfare, and levies such as ACC.

If people earn an extra dollar of labour income, the government will take 24 or 33 percent in income tax. Their entitlement (if any) to the low income earner rebate, family support, New Zealand superannuation and income support may also be reduced. If take-home pay is spent on alcohol, tobacco and petrol, the government will collect excise taxes. In addition, GST is applied to most goods and services at the rate of 12.5 percent. All of these taxes should be taken into account in calculating effective marginal rates of tax.

Effective marginal rates of tax vary considerably from taxpayer to taxpayer and are not easily calculated. They are unlikely to be below 40 percent for many people, they are possibly above 50 percent for most taxpayers and they can exceed 100 percent.

High taxes are especially damaging to the economy. This point was recognised by President Franklin Roosevelt in 1932 when the average rate of tax was lower and the US income tax was not quite two decades old. Complicated economic analyses have established that the adverse incentive effects of taxes rise more than proportionately as effective marginal rates of tax rise. Thus an increase in the effective marginal tax rate from 50 to 60 percent is more harmful than an increase from 20 to 30 percent. For this reason, we should be particularly sceptical of proposals for increased expenditure from the present high level.

There is growing international evidence that economies perform best when the size of government is constrained. The faster growth of the Asian tigers relative to the OECD countries as a group supports this conclusion. Gary Becker, a Nobel prize winner in economics, has written:

> National plus local government spending in some 50 non-communist countries went from an average of about 32 percent of GDP in 1972 to 36 percent in 1980 and 40 percent in 1985. I believe that this contributed to the sharp decline in world economic growth in the 1970s and 1980s from the previous two decades.

Becker's description fits well with New Zealand's experience.

New Zealand's tax policies are rarely examined in the context of international trends. Most New Zealanders would be surprised to know that in the five years to 1990, nearly all OECD countries reformed their income taxes. The focus was on lowering marginal tax rates, especially top rates of tax. The average top rate was reduced from 54 percent to 44 percent. New Zealand's top rate was reduced from 66 percent to 33 percent.

The international trend to lower marginal rates of tax was influenced by the following factors:

- the revenue generating ability of tax systems was under stress in the 1980s because of the sharp rise in tax burdens and slower growth referred to by Becker. Lower tax rates were often accompanied by a broadening of the tax base (that is, income that was previously exempt or tax-favoured was taxed on a normal basis). The overall result was increased tax revenue;

- the findings of a number of studies in the 1970s and 1980s to the effect that the economic costs of high and uneven taxes were much larger than previous studies had suggested; and

- the growing interdependence of the world economy. Individual countries are increasingly required to take account of the greater international mobility of capital, production, firms and people.

Higher rates of tax have often not produced the intended lift in revenue because of their harmful effects. On the other hand, significant cuts in tax rates have improved economic performance in some countries and cushioned the losses in revenue.

Over recent years there has been growing interest in quantifying the costs of taxation. The best, but unfortunately impractical, procedure would be to invite all taxpayers to nominate the amount of money that they would be prepared to pay to be free of tax and tax returns for ever. Provided that taxpayers could be sure that future governments would honour their side of the bargain, this approach would put a value on the true costs of taxation. How much would you offer? I suspect the answer is a very large sum.

Less ambitious studies attempt to measure the so-called deadweight costs of taxes. These costs are given this name because they are a drag on the welfare of the community. Last May the Business Roundtable published the results of the first study of the deadweight costs of New Zealand taxes. It was undertaken independently by respected international consultants, including Professor Erwin Diewert of the University of British Columbia.

The study found that the marginal costs of taxes on income from labour (mainly income tax) and consumption (primarily GST) are around 18 percent and 14 percent respectively. These findings imply that an additional dollar of government expenditure funded from tax on labour income and consumption would need to yield net benefits of $1.18 and $1.14 respectively to break even. If those benefits are not forthcoming, the proposed project should not proceed because there would be no net gain. Similarly, if existing expenditure programmes are not generating sufficient benefits, they should be curtailed and debt, and later taxes, should be lowered.

The study did not take into account taxes on capital income (for example, taxes on interest and profits), or administration and compliance costs. Its results are likely to be conservative. In an open economy, capital is highly mobile and the economic costs of taxing capital are likely to be large. Few recent studies for other countries have produced lower estimates of deadweight losses.

A separate study of compliance costs was undertaken by the Institute of Policy Studies at Victoria University. Compliance costs are incurred in completing forms and keeping records to satisfy tax obligations. They are borne by the private sector whereas administration costs are funded in the first instance by the government. The compliance costs of the main business taxes were estimated to be $1.9 billion for 1990/91. This figure does not include the entertainment tax which came later. If these costs were met by the taxpayer, 'Vote: Compliance' would be the fifth largest item of government expenditure after social welfare, health, education and debt servicing, and ahead of law and order, defence and core government services. The study found that compliance with the tax code took up 46.5 million hours of management time and cost over $600 million in external advisers' fees and miscellaneous costs. If every person in a town with a population of 22,350 (say, Blenheim) worked 40 hours a week for a year, their total working year would amount to 46.5 million hours. Clearly the compliance costs of business tax alone are very large, and they fall more heavily on small firms than larger firms where the job can be delegated and which have more sophisticated information systems.

The advocates of additional expenditure claim that people - usually other people - are willing to pay higher taxes. Paul Johnson, the eminent British historian, provides a more plausible view:

> People do not like paying taxes. They have never done, in any country, in the whole of history. It is true that, around mid-century, in many advanced countries, there arose a somewhat masochistic belief among the educated middle class that it was 'right' to pay high direct taxes to give the 'less fortunate' the welfare state they needed. But this mood has long passed, even in countries like Sweden and Denmark, where it was most deeply rooted. And it has never been shared by the working class, which regards tax-avoidance, where safe, as a duty you owe to your family.

Johnson's view is supported by an examination of people's actions which are a more reliable indicator of their preferences than their purported responses to opinion polls. Various pieces of evidence suggest that most people do not wish to pay higher taxes:

- tax avoidance is widespread in advanced countries with high tax rates. Governments have to use their coercive powers to the full to encourage compliance with the tax laws;

- a large administrative apparatus is required to collect taxes. There are more people employed to collect taxes (5,500) than are employed in the army (4,540), airforce (3,440) or navy (2,340). There is about one tax collector for every 1.2 police officers;

- the income tax legislation has changed out of all recognition from the Janet and John version of the 1890s to the present incomprehensible tome as legislators have responded to the ingenuity of taxpayers; and

- voluntary payments of taxation are, to the best of my knowledge, rare. An unexpected receipt of voluntary tax has never embarrassed Treasury forecasters.

People who believe that higher taxes should be imposed could make additional payments to the government. How much extra tax have academics advocating higher tax contributed? The churches have been slow to offer to give up their tax exemption to help fund the higher expenditure that they advocate.

The tax system is often seen as a way of redistributing income. However, tax policy is a weak instrument for this purpose. The promotion of a fair distribution of income is best advanced by a vigorous, growing economy and flexible labour markets that sustain high levels of employment. East Asian countries, with small government sectors and low tax rates typically have a more equal income structure than other developing countries with large government sectors. By putting a wedge between pre- and post- tax wages, taxes discourage employment. High unemployment is usually the main reason for increasing disparities in income. The policies that our organisation has advocated, such as the Employment Contracts Act, have been influenced by the experience of countries which have high rates and equitable patterns of growth. Some 70,000 additional jobs have been created since the ECA was passed. Curiously, it has been opposed by many church and welfare groups.

The claim that the rich are getting richer while the poor are getting poorer is often made. However, it is usually only based on one simplistic statistical series, the survey of real disposable incomes. The survey has been withdrawn by Statistics New Zealand because it does not adequately reflect trends in the less regulated economy. Furthermore, the survey is far too narrow to draw such a conclusion. It does not take account of the many ways in which people have benefited from recent reforms.

To the extent that people in higher income groups have benefited from cuts in marginal tax rates, an interesting question is whether they have ended up paying more or less tax. Several US studies have shown that people on high incomes have been paying a higher share of income tax despite tax cuts made in the 1980s. One reason for this result is that, as in New Zealand, many tax loopholes have been closed. A less detailed analysis by Inland Revenue shows clearly that the tax burden imposed on high income earners in New Zealand increases progressively with taxable income. In 1993, taxpayers accounting for the top 25 percent of taxable income accounted for 62 percent of total tax assessed. The top 1 percent accounted for almost 10 percent of tax assessed. Contrary to public utterances, the results are not significantly different from those recorded in 1981.

I am strongly of the view that there is no valid case for higher taxes now or in the near future. Now that we are running budget surpluses, the only reason for raising taxes would be to expand the size of government. Total government spending is more than sufficient to carry out its legitimate roles. Our counterpart organisation in Australia, the Business Council, estimated that the core government functions amount to no more than 4 percent of GDP. As President Roosevelt noted, increasing taxes won't make for a fairer society and it certainly won't make for a prosperous one. If New Zealand stays on track, repays debt and regains a triple A credit rating, we can look forward to the prospect of lower rather than higher taxes for the first time in decades. That is a prize that is well worth striving for.

ROTARY CLUB OF KAPITI

STAYING IN THE BLACK

ALAN HARWOOD
GENERAL MANAGER
AMP SOCIETY

KAPITI
7 JULY 1994

STAYING IN THE BLACK

Last week's budget was a major event in that, for the first time in nearly twenty years, the government recorded a surplus on its financial balance. Much of the surplus is to be applied to debt repayment. The government also published its short-term fiscal projections and long-term objectives which indicate substantial and increasing surpluses and further reductions in public debt.

This evening I want first to review how it is that we reached our present position of massive indebtedness and, at long last, of financial surplus. My purpose is not simply historical but to emphasise that the pressures for fiscal rectitude are few while the incentives to spend, tax and borrow are very powerful. The dangers of slippage and of giving way to the pressures which led us into our present situation have not disappeared.

My second aim is to outline what a strategy for staying in the black might look like and how it compares with the budget projections.

I also want to emphasise that fiscal management must be tied in with other policies if we are to achieve the economic growth we require. I shall therefore conclude by outlining some of the other reforms that, in my view, must be pursued if we are to achieve comprehensive economic and social success.

My overall message is that we are in a position of great opportunity for locking in and reinforcing the hard-won gains of the last ten years. But hard-won gains are easily lost if we just rest on our laurels. We need continuing high rates of economic growth, tight expenditure control and a prudent approach to tax cuts if we are to stay in the black. I am concerned that the pressures within our new political environment may weaken our resolve to maintain disciplined economic management.

High levels of government spending, taxation and deficits have been part of the New Zealand scene for most of the last twenty years. For the previous twenty-five years, from 1950 to 1974, central government spending on goods, services and transfer payments ranged between 22 and 25 percent of GDP. By the late 1980s this had increased to 38 percent. To partially finance this expenditure, taxation per capita more than doubled between the early 1970s and the early 1990s. These tax increases were made at a time of very limited increases in real incomes.

Until the last fiscal year, the increase in tax revenue was, as we all know, not enough to fund government outlays and substantial borrowing has been required. Despite the asset sales of recent years, real gross public debt per capita in 1993 dollars had risen from a post-World War II low point of around $7,500 in 1974/75 to nearly $14,000 by 1990. This contrasts with the generally very prudent approach to debt adopted for most of our history. After World War II, for example, governments progressively reduced public debt per capita.

High government spending, high levels of taxation and increasing debt levels have not, of course, been confined to New Zealand. Many other countries in the developed world have engaged in reckless government financing. Why did it happen and will it happen again? It is easy to identify some immediate causes such as the effect of the oil price rises in the early 1970s, but this doesn't explain nearly twenty years of addiction to deficit financing. There is probably a complex mix of causes, but there is no reason to think that the pressures to spend, tax and borrow are no longer present and could not again wreak similar damage. After the budget, there was a constant stream of criticism of the government from opposition parties and interest group representatives for not spending more.

We need to be vigilant that recent history does not repeat itself. It is up to each of us to ensure that politicians know that we expect political parties to state clearly their fiscal policies and targets in their manifestos, and that fiscal responsibility is one of the key issues on which their performance will be judged. In this regard the Fiscal Responsibility Act is a splendid piece of legislation and will do much to keep citizens informed of government intentions. The budget documentation, prepared in accordance with the Act, is most impressive. The government deserves considerable credit for this achievement.

There is, of course, an important moral issue in the national debt situation. This is simply that for most of the last twenty years we have been sustaining a standard of living well above the nation's earning capacity by borrowing, and we are expecting our children and their children to repay the debts we have built up. This has been referred to as inter-generational theft, and most politicians and most voters have been party to it. Simon Upton has put it this way:

> Most MPs in Parliament today have, at some time, been part of a government that added to the public debt. If they haven't, they almost certainly criticised those governments - National and Labour - for not spending enough. So have most voters. In other words, all of us had our hands in our children's pockets.

Raising debt to meet temporary difficulties or to fund capital formation is entirely appropriate for governments as it is for firms or households. However, it is only fair that those who benefit from debt financing should, as far as possible, be the same people who incur the cost of generating the surpluses with which to meet the repayments. From this perspective, nearly twenty years of deficit financing is far too long and we are obliged to repay as fast as we reasonably can.

The business organisation of which I am a member, the New Zealand Business Roundtable, has been seeking to play its part in this task of raising our expectations of our political leaders. This brings me to my second topic - what should our fiscal path look like and how do last week's budget figures compare with it.

In its April 1992 report *Budgetary Stress*, the Business Roundtable urged the government to adopt a number of explicit fiscal targets. We said:

- the share of government expenditure in national income should be reduced to between 25 and 30 per cent by 2000 with a rate of reduction of 1 to 2 percentage points a year;

- the financial balance as a percentage of GDP should be improved by around 2 percentage points a year on average; and

- net public debt (local and central government) relative to GDP should be reduced by 2000 to the average ratio for OECD countries, then estimated at about 31 per cent.

At the time the government dismissed these targets as too ambitious. However, the share of government expenditure in GDP has fallen from 39.3 percent in 1991/92 to 34.8 per cent in 1993/94 - somewhat faster than the recommended 1 to 2 percent rate of reduction. The financial balance as a percentage of GDP has reduced from minus 2.3 percent to plus 0.6 percent - a considerable improvement but below the proposed 2 percent average. Both outcomes have been assisted by higher than expected growth which may be partly due to cyclical factors.

The net debt position relative to GDP has reduced from 47.9 percent in 1992/93 to 42.1 percent in 1993/94 which is about the same as the OECD average for central government debt of 43.9 percent. However, the government's intended ratio of less than 20 percent by 2003/04 is below the Business Roundtable's suggested target. Our target was clearly too high given what we now know about the Crown's negative equity position.

I would draw a number of lessons from this performance against targets dismissed as unrealistic only two years ago. First, if we want sustained recovery and continued economic and social progress we must aim for it, and not allow ourselves to be talked into more modest expectations. Secondly, once we begin to do the right things it becomes easier to do more of them. We enter a virtuous spiral of a relatively smaller government sector and a larger, more competitive private sector. Business investment increases, employment grows, and government revenue increases while government expenditure on transfer payments falls. Increases in government revenues and falling government outlays lead to surpluses which can be applied to debt and/or taxation reduction. Lower government debt means lower debt servicing costs and a further improvement in the government's fiscal position. And so on.

The third lesson I would draw is that the structural reforms of the 1984-88 period were not enough - fiscal problems, especially on the expenditure side, and labour market issues remained outstanding. Addressing these and other concerns helped to halt the downwards spiral and started the economy on its upward path, enabling it to build with impressive speed on the reforms of the earlier period. Thus fiscal management is an integral part of broader economic management, and all the parts must be in place if the economy is to work well.

How do we assess last week's budget? Financial surpluses are forecast of $730 million in 1994-95, $2.5 billion in 1995-96 and, in the absence of tax cuts, $4.5 billion in 1996-97. We should, however, keep in mind several important points. First, the future rarely turns out as forecast: many factors can alter revenue and expenditure growth. Promising scenarios can always be overturned by events. Secondly, the growth in net financial expenditure in 1994/95 of $1.4 billion is substantial. It is projected to decline by only $546 million during the subsequent two years. Thus the fiscal surpluses are very largely due to burgeoning revenue rather than reductions in total expenditure. Thirdly, the net debt position is still very serious. At about 42 per cent of GDP, it is far too high. We are also very reliant on overseas debt, in other words the debt problem is one of mix as well as level. However, I am pleased to see that the government intends to concentrate future debt reduction on retiring foreign currency loans.

Overall, though, the present position presents tremendous opportunities for improving our fiscal position and restoring a triple A credit rating. With great opportunities come great responsibilities, and all of us should be watching the government closely to ensure that they are not squandered. Also, risks remain. A serious downturn in our terms of trade or a severe natural catastrophe could wipe out surpluses virtually overnight.

What are the main concerns given these projections? First, I suggest, must be the restoration of a triple A credit rating. Credit rating agencies look at a variety of factors, including various financial ratios, in order to arrive at an overall assessment of a country's credit risk. One ratio which would clearly have to be improved is the Crown's net worth. This is the difference between the Crown's assets and liabilities. At present the Crown's net worth is minus $6 billion. It is, however, projected to rise to plus $3.6 billion by 1996/97 (assuming no tax cuts) and plus $14 billion by 2003/04. These are encouraging projections. How much further we should aim to increase our net worth will require more research. I would note, however, that we are a small, trade-dependent country. From this perspective, a substantial buffer against significant downturns in our terms of trade and other adverse events would seem only sensible.

A second concern is the level of government expenditure. I have already noted that this is still rising. I am not convinced that all existing government expenditure is well spent. I believe that a significant part of present government activity could be left to the private sector, taking government expenses below the 27 percent of GDP presently forecast for 2003/04. In particular, there is considerable scope for reviewing the role of the government in areas such as health, education and retirement provision. The disincentive costs of taxation are significant, and we need to ask why the government should remove cash from people and make their expenditure decisions for them.

The third issue is the point at which the government starts reducing tax levels. The government presently envisages this as an option for 1996/97. However, on present projections, this will be the point at which the Crown's net worth position turns positive. Starting to lower taxes too soon could jeopardise the restoration of a triple A credit rating and raise serious questions about the government's commitment to fiscal probity.

In terms of the age profile of our population, we are now at the start of a decade which is particularly favourable for improving our financial ratios as the post-war 'baby-boom' generation moves through the labour force. Thus, for the next decade or so, superannuation expenditure will fall as a share of GDP, reflecting lower numbers as well as the phased increase in the retirement age. However, from about 2010 these 'baby-boomers' will be retiring, placing considerable additional pressure on superannuation and health payments. It is important that we make good use of this 'window of opportunity'. If we don't, we will be asking subsequent generations not just to shoulder the debts for which we are responsible but to do so in much less favourable circumstances than we are now facing.

The key question is whether the government and other political parties have the determination to turn projections into firm political commitments and policies. There can be considerable slippage between projections and outcomes. If we want to enjoy a larger measure of success, we need to press on with reforms that will create wealth and spread it fairly.

It is therefore pleasing that the government is proceeding with its plans to deregulate coastal shipping. The Fiscal Responsibility Act is a first class piece of legislation which complements the Reserve Bank Act. However, it is quite hard to think of other areas where recent progress has been at other than a desultory pace. The budget offered no vision or plans for increasing our growth potential. What else needs to be undertaken if we are to achieve continued economic growth and higher levels of employment?

A priority area for government action is privatisation. This has produced enormous gains in the efficiency with which national resources are being used, as well as enabling reductions in government borrowing requirements and debt. With such a proven track record of gains to the community, it is astonishing that the government has had little to say about it and has slowed the process right down. The government is still the owner of major commercial enterprises including electricity, forestry, postal services, radio and television and Landcorp. In addition to selling these and other assets, we should be exploring the possibility of more commercial approaches to activities such as roading and, in the local government area, water and sewerage. It is disappointing that no major new initiatives on privatisation were announced in the budget.

Other areas for policy research are local government, accident compensation and the fire service. One possibility that could usefully be examined is the provision of legislation for local government along the lines of the Fiscal Responsibility Act.

On labour market issues, there is much work to be done in relation to the still unacceptably high levels of unemployment. The Employment Court is making decisions which raise the costs and risks of taking on labour. The recent OECD report on unemployment has drawn attention to the problems created by minimum wage legislation and open-ended benefits. President Clinton has recently proposed a two-year time limit on welfare. I hope the Prime Ministerial Task Force on Employment will examine these issues.

On regulatory issues, further work is needed on the restructuring of the electricity industry. The Resource Management Act should be fine-tuned in the light of experience. Work undertaken for the Business Roundtable has highlighted the distortions and economic costs of the statutory restrictions on the export of some of our main agricultural products. The present tariff review is an opportunity to maintain or accelerate the rate of tariff reductions post-1996 in order to promote further improvements in our international competitiveness. There is much to be done to improve the performance of our education and training systems. The list of issues with the potential to build on the gains so far achieved is a long one.

In conclusion, let me emphasise that we continue to face considerable risks in an increasingly competitive world. Our low credit rating puts a floor on the cost of capital for all resident businesses. Over the last ten years we have made some enormously positive and innovative reforms - the wide ranging reforms of 1984-88, the Reserve Bank Act, the Employment Contracts Act, the Fiscal Responsibility Act and so on. We are beginning to see the returns in the form of higher living standards, significantly lower unemployment, and improvements in financial ratios.

The danger now is complacency. We have, I suggest, moved from the position of 'borrow and hope' to one of 'hope'. The 'hope', of course, is that economic growth will continue unabated, generating the dividends which enable the government to "deal to debt" and address other problems, particularly unemployment. The problem is that there is little in the budget statement that focuses on growth and the policy environment required for it. There is too much in the 'body language' of the budget text which suggests that the government thinks the hard decisions have been taken and its job is now just to distribute the gains - for which there is already no shortage of applicants. I have outlined some of the policy areas in which much more needs to be done.

There is, I think, wide public understanding about our debt position and the need for continued economic growth. We now need to raise the level of understanding and debate about the further policy reforms that are needed if we are to stay in the black and do better yet.

NEW ZEALAND LOCAL GOVERNMENT ASSOCIATION
CONFERENCE

TRANSPORT : VISIONS 2010

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

PALMERSTON NORTH
15 JUNE 1994

TRANSPORT : VISIONS 2010

The government's 1993 vision for New Zealand entitled *Path to 2010* proposed as a goal an economic growth rate of 3.5 - 5 percent a year between now and the year 2010. If the economy performed at the top end of that range, production of goods and services would double in the period. The economy would be twice the size it is now.

Such a change in our economic fortunes is clearly desirable. Because our population will grow relatively slowly, it would mean a large increase in material living standards and the availability of jobs. It is also entirely achievable. It would only lift New Zealand to the per capita income levels of today's high income countries, and of course they will move on in the meantime. And New Zealand could be a green tiger: given prudent management, there is no reason to expect shortages of energy or other natural resources to be a significant constraint on growth in that period.

Whether we achieve that vision will depend on whether we carry on making sound and often politically difficult economic choices. It will also depend on whether the private sector copes with the challenges of success.

These challenges are easily illustrated in the transport sector. On current projections tourist numbers could double to 2 million by the year 2000 and grow by another million in the following 10 years. Forestry exports could also double. Both these industries are major users of transport services. More generally, exports could easily reach 50 percent of GDP by 2010, up from the present level of one third, as the economy becomes more open. Import penetration would rise in parallel. The more trade-oriented economy could require more than a doubling in transport services - a major undertaking.

Fortunately the transport sector is in a far better position than it was 20 years ago to adapt to new demands. Since the Wilbur Smith report in the early 1970s we have seen comprehensive reforms in most parts of the sector. The highlights have been deregulation of road transport, aviation, buses and taxis, the road user charges system, the removal of rail protection, reforms of ports, shipping and the waterfront, the privatisation of Air New Zealand, the Shipping Corporation and the Railways Corporation and the restructuring of the Ministry of Transport and Transit New Zealand. Deregulation and privatisation have produced dramatic improvements in costs and services. The commercial ethic has replaced the bureaucratic ethic and the process of ongoing restructuring and the uptake of new technology can now occur more quickly and smoothly.

In the period ahead I expect these trends will be reinforced. Deregulation produces chain effects in the system as people discover better ways of doing things once the constraints are removed. It takes many years for organisation cultures to change, as experience at Air New Zealand and New Zealand Rail has shown. Only now are we starting to reap the full benefits of the changes of the last 10 years.

At the commercial level we can expect an increasing customer orientation of transport services with an emphasis on just-in-time deliveries, damage-free handling and improved safety. There will be a major role for information technology with developments such as satellite tracking of trucks and trains, electronic data interchange and fuel optimisation controls. Firms must continue to benchmark themselves against international best practice (where it is cost-effective to do so) and meet ISO 9000 and other quality standards. Many of the future gains in productivity and efficiency will come from new investment which will be dependent on maintaining competitiveness and profitability.

At the policy level, there is a large outstanding agenda. There are always opportunities for improvements in economic organisation with advances in technology and economic thinking. Liberalisation of coastal shipping is likely to be the next significant initiative, and could be followed by further airline deregulation. Well before 2010 New Zealand transport users are likely to have access to cars and other transport equipment at world prices as tariffs and other trade barriers are removed, with large gains in cost, safety and fuel efficiency. The benefits will accrue to private motorists and to industries such as the tourist, taxi and rental car industries. Another foreseeable event is the full deregulation of postal services allowing new private sector competitors to enter the market.

Policy should continue to concentrate on opening markets to competition, neutral tax and regulatory treatment of all transport modes and private sector provision of transport services, with the government's task being to set high quality rules to govern the sector's operations.

In my remaining time I wish to highlight the two areas where I believe some of the largest gains from policy initiatives could be realised. In both cases local government is a significant player.

The first is local government's remaining involvement in ports, airports and bus services. This is an anachronism that should be eliminated as quickly as possible for all the familiar reasons. Local authorities have no need to be in these risky commercial businesses. All will need capital to expand as the economy grows, which local governments will be ill-equipped to provide. The disciplines imposed by private ownership and capital markets will encourage superior performance, and the businesses will be less subject to political and interest group pressures. It is no response to say that some private sector businesses fail and the occasional government-owned business succeeds: the evidence is now clear that, on average and over time, private firms do a better job of meeting consumer needs.

Although some local authorities have moved to sell their interests in port and bus companies, progress in general has been slow. In its *Transport Directions 1994-99* document, the government has reaffirmed its policy of encouraging local authorities to divest transport operations to the private sector rather than forcing them to so. I agree with this approach, but it is time for local government to move into the fast lane. In Australia last year, even a task force headed by the secretary of the Australian Council of Trade Unions, Bill Kelty, recommended the privatisation of government airports. New Zealand is lagging well behind policy and practice on privatisation in other countries. Outmoded thinking and vested interests should not be allowed to stand in the way of the wider community interest in having key transport services run by the private sector.

The second priority area for attention is roading. The 93,000 kilometre roading network is one of New Zealand's most expensive assets. Compared to other parts of the transport sector, there has been relatively little change in the administration and operation of the roading system. There is a growing recognition that there are large potential gains from reform of roading. It is interesting to note that six of the ten strategic initiatives on economic sustainability identified in *Transport Directions* relate to roading.

Local government's interest in roading has recently centred on the allocation of fuel taxes. I believe this focus is far too narrow and much of the analysis has been simplistic. In particular, it has not taken proper account of the capital costs of the roading system. If the depreciated replacement cost of the network were to be fully reflected in capital charges, a case could be made that the current level of taxation is grossly inadequate. A contrary case could be mounted on the basis that there is enormous excess capacity and low marginal operating costs in roading and that current taxes exceed the short-run marginal costs of road transport. The point is that a much more sophisticated analysis is required on this issue.

More importantly, there are major problems of conflicting objectives, lack of accountability, weak responsiveness to consumer preferences and management inflexibility in our current structures for roading administration. These are particularly acute in respect of new investment, where even minor gains in the efficiency of investment decisions could be significant for the economy as a whole.

Given the progress that has been made in overcoming similar problems in other state-owned enterprises, there is a compelling argument for examining the applicability of a more commercial model to roading administration. Such options are becoming more feasible with the rapid advance of electronic billing technology. If Transit New Zealand and other roading operators had access to revenue streams related to road usage, commercial incentives would stimulate efficiency improvements and a search for what users really value. It is not clear that monopoly problems would be more problematic than with other utilities provided sound regulatory polices were followed.

I believe roading is emerging as the issue of the future among transport policy makers around the world. Countries such as Singapore and Norway are well advanced in adopting road pricing schemes. Private toll roads are being constructed all over Asia. Germany has announced plans to privatise its autobahn system. These developments are being driven by demands for new roading capacity and the reluctance of governments to finance high capital expenditures.

Faster growth in New Zealand will place similar demands on our transport infrastructure. For both economic and environmental reasons it is important that we make the most efficient use of existing transport assets and sound decisions on the expansion of capacity, both within and between modes. Local government has a major role to play here. It has tended to be a follower rather than a leader in the economic reforms of the last decade. In respect of privatisation and reform of roading, there is no reason why it could not now show the way to central government.

NEW ZEALAND LOCAL GOVERNMENT ASSOCIATION CONFERENCE

EMERGENCY MANAGEMENT: BEYOND 2000

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

PALMERSTON NORTH
15 JUNE 1994

EMERGENCY MANAGEMENT: BEYOND 2000

The government has addressed the provision of disaster insurance. The most appropriate arrangements for the provision and funding of fire services are now on the agenda. The chief executive's review of the fire service has raised the wider issue of the organisation of civil defence and ambulance services. While the management of natural disasters affecting agriculture is not a prominent issue at present, the water crisis in Auckland and the recent droughts in the South Island are forceful reminders that urban and rural life can be significantly affected by climatic conditions.

The New Zealand Business Roundtable has taken an interest in policies affecting emergency management from an overall national perspective. We prepared several reports on the reform of disaster insurance. A report on the provision of fire services and related activities will be finalised shortly. We have been liaising with the New Zealand Local Government Association and several other organisations in this work. We have a general interest in the local government field.

There are two main reasons for reviewing emergency management policies. First, government policies relating to emergency management may bias incentives for private firms and individuals to take steps to avoid losses, and to minimise losses should an adverse event occur. If incentives faced by individuals and firms are distorted, they will make the wrong investments in loss prevention and minimisation, and community welfare will be reduced. Resources would be diverted from uses that would provide a higher return to the community.

Existing arrangements distort incentives in a number of ways. Two examples may illustrate this point.

The first concerns fire services which are largely funded by a levy on fire insurance. The levy does not reflect the actual risk of fire for the relevant class of property, the resources that may be required to extinguish a fire, the resources that are available to do so or the extent to which fire services are used by the property owner. In these circumstances, the owners of high risk properties may be discouraged from investing in fire prevention and loss minimisation because the levy they face is too low. On the other hand, some property owners who are over-charged will be encouraged to invest excessively in these activities. Either way resources are wasted and national income is reduced.

The second example concerns rural risk management. If the government compensates farmers for losses from adverse climatic conditions, for example through favourable tax treatment, they will be encouraged to take greater risks. Losses would be accentuated. Farmers may, for example, adopt higher stocking rates than otherwise or make less hay. If the weather is favourable, the farmer would be rewarded by increased output and income. On the other hand, should the weather be adverse, part of the loss is passed to taxpayers.

A broad approach should be taken in examining whether incentives are appropriate. A review of the management of the risk of fire, for example, should not be restricted to whether the country spends too much or too little on fire services and whether fire services operate efficiently. A wider question is whether the right incentives are in place to avoid fires and to minimise losses from fires that do occur. This requires an investigation of the efficacy of regulations aimed at promoting safety in factories, public buildings and homes.

From an economic perspective it is unlikely to be desirable to eliminate all loss associated with fires, civil defence emergencies or adverse natural and climatic events, even if this were practicable. The community should invest in avoidance and loss minimisation activities up to the point where the marginal social costs and benefits are equal. Firms and individuals can, for instance, be expected to bear the risks of a fire where this is cheaper than additional protection measures. While this proposition may appear hardhearted, few people would argue that a fire appliance or an ambulance should be placed on every street corner or that stop banks in rural areas should be designed to withstand, say, a 1 in 100 year flood. We accept that a balance between costs and benefits is required.

The second main reason for examining emergency management is to improve the efficiency of the relevant services. Fire, civil defence, some ambulance services and most regulatory functions are undertaken by government agencies. These activities should be examined carefully to identify those services which should be undertaken by the government and those which should be privatised, corporatised or contracted out.

Over the last decade or so many countries have scrutinised the efficiency of government agencies relative to their private sector counterparts. There is overwhelming evidence that private firms are more efficient than public agencies because markets are a stronger discipline on management than political oversight. The OECD, for example, has recently reported that contracting out a range of government services in four countries produced efficiency savings of between 6 and 50 percent, with most savings falling between 15 and 25 percent.

In the remaining time I will concentrate on fire services. Policy changes in this area of emergency management are the most likely in the near term and could have important implications for civil defence and ambulance services.

The recent review of the Fire Service by the chief executive was a welcome first step. The review:

- acknowledged that the role of the Fire Service needs to be clarified. The deficiencies of existing legislation and policy guidance on its role were noted;
- recognised the inadequacy of the management structure and management practices;
- accepted that there was a major problem of inefficiency in the Fire Service; and
- provided a platform for addressing excessive manning and the terms and conditions of employment of paid firefighters.

These findings vindicate the call by the Local Government Association, the Business Roundtable and other interest groups for a thorough review of the issues. This had been resisted by the previous chief executive on the grounds that there were no problems with the Fire Service.

There are important aspects of the provision and funding of fire services that were excluded from the chief executive's review or discussed only briefly. These included:

- funding. The review proposed that the New Zealand Fire Service Commission fund all emergency services. The method of funding was not discussed;
- the role of the New Zealand Fire Service. Although an expanded role in the provison of rural fire services and rescue and ambulance work was proposed,

there was no 'first principles' discussion of the role of the Fire Service in the report. Fire safety and fire prevention were not considered in any depth; and

- the role of local government in the organisation of fire services.

Our organisation is sceptical that a continuation of the trend towards collective provision of fire services on a national basis, as advocated in the review, is the correct approach. The review explicitly rejects the view that fire and related services should be provided on a competitively neutral basis. It states that "The New Zealand Fire Service should be the preferred provider of Fire Protection and emergency response until or unless it is found not to be providing a good, economic, cost effective service". This would seem to require the nationalisation of some ambulance services.

Other weaknesses in the report include, in our view:

- an inadequate focus on institutional structures (including governance and accountability structures) which allowed the present inefficiencies to develop. An independent review addressed this aspect but its findings were not accepted;

- a failure to recognise that pay and conditions should not exceed levels needed to recruit and retain firefighters. Proposed increases in pay were not justified on these grounds; and

- inadequate attention to equipment and the location of stations which are matters within the chief executive's control.

Overseas experience suggests that there may be economies from the combined operation of the fire and ambulance services. The Business Roundtable is doubtful of the merits of that approach while the Fire Service is subject to no real competition. There is a substantial risk that the excessive pay and conditions enjoyed by firefighters would spread to ambulance services, that the incidence of strikes among ambulance services would increase, and that the organisational structure that permitted inefficiencies to go unchecked for an extended period would be applied to ambulance services.

The efficient provision and funding of fire services and other emergency servies should be examined thoroughly. The chief executive's report provides a useful start but a broader perspective is necessary. Local government has an important part to play in examining its role in this field in terms of valid criteria for government intervention. Policy stability depends on a sound basic framework for policy in the emergency management area being developed.

SUBMISSION BY THE
NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND CITY COUNCIL'S 1994/95 DRAFT ANNUAL PLAN

JUNE 1994

AUCKLAND CITY COUNCIL'S
1994/95 DRAFT ANNUAL PLAN

1.0 Introduction

1.1 The New Zealand Business Roundtable (NZBR) welcomes the opportunity to present this submission to the Auckland City Council. The NZBR is an organisation of chief executives of some 50 of New Zealand's largest businesses. It is committed to contributing to the overall development of New Zealand. We support policies that advance the interests of the wider community rather than sectional interests. Our submission has been prepared from this perspective.

1.2 Local government is a large undertaking. A survey by *Management* put total expenditure by New Zealand's largest 50 local bodies at $2.83 billion or 3.4 percent of GDP in 1994.[1] This expenditure is equal to almost one-tenth of central government expenditure. Local bodies surveyed managed assets amounting to $25 billion.

1.3 Auckland City is itself a substantial business. In the 1994/95 year, proposed gross expenditure, including capital works, amounts to $365 million or $391 million if proposed investment in commercial property is correctly included. Auckland City's total assets are forecast to amount to $2.1 billion at June 1995. It thus ranks with the largest New Zealand companies.

1.4 The spending, taxing, borrowing and regulatory policies of local government have a pervasive effect on the well-being of the community. If local government uses resources in activities that yield a lower return than that available in other sectors, national income and output are reduced. Unjustified rate increases, for example, reduce the competitiveness of businesses with an adverse impact on employment. They drive residents and businesses to centres that offer a more attractive financial environment. Inappropriate regulations have similar effects on residents and businesses.

1.5 Local government activities have not generally been subject to the same level of scrutiny as that applied to many central government activities, and the pressure to upgrade the performance of local government has not been as intense as that faced by the private sector. As a consequence, local government has not made sufficient efficiency gains and lags behind the progress recorded by other sectors.

1.6 Privatised or corporatised businesses have achieved productivity gains of the order of at least 20-30 percent. The OECD has recently reported that moves to contract out a range of government services in four countries produced efficiency savings of between 6 and 50 percent, with most savings falling between 15 and 25 percent.[2] Comparable gains should be possible in the local government sector. There is little evidence, however, that councils have set their sights firmly on realising such gains within an appropriate timeframe.

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1 "New Zealand's Top 50 Local Bodies", *Management*, April 1994, pp 29-53.

2 *OECD Economic Outlook*, No. 54 (December 1993), Organisation for Economic Cooperation and Development, Paris.

1.7 The need for increased efficiency in the local government sector is now generally acknowledged and worthwhile steps have been taken by a number of councils, including Auckland City. There is an urgent need, however, to accelerate progress toward achieving a highly efficient and tightly focused local government sector.

1.8 The national economy began to recover in 1991 and is now recording solid growth in output and employment. After an initial lag, indications are that the Auckland economy is gaining strength. It is important that the decisions of councils in the region reinforce improved growth prospects.

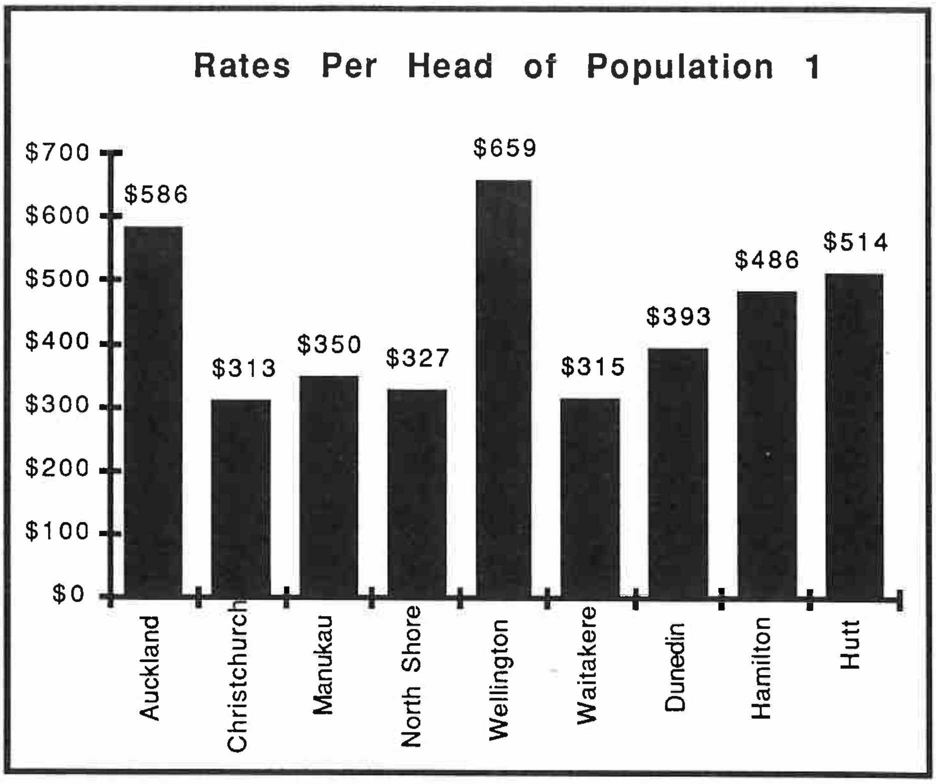
2.0 General Assessment

2.1 Since the advent of the local government reforms, Auckland City has taken worthwhile steps aimed at putting its financial affairs on a more prudent footing. These include:

- some reductions in current expenditure;
- a reduction in public debt from $190 million to around $140 million currently;
- extension of some user charges, such as the installation of water meters for residential dwellings;
- arm's length pricing of internal services and the implementation of limited capital charging;
- the sale of some non-core assets, such as the Auckland abattoir and the planned sale of the BASS booking office; and
- the preparation of a 20 year strategic plan.

2.2 Households, businesses and tourists consider a wide range of factors in deciding where to live, locate or visit. There is vigorous competition between cities to retain and attract jobs, visitors and businesses. A key consideration is the overall rate burden.

2.3 Auckland City has the second highest per capita rate burden after Wellington. Auckland City's per capita rates ($586) are over 75 percent higher than those in Manukau, North Shore and Waitakere cities (which average $330). Rates per head of population in 1993/94 for New Zealand's 9 largest cities are shown in the figure below. The information presented is taken from a survey by *Management*.



2.4 Under the draft plan net expenditure is budgeted to increase by 5 percent in 1994/95. Thereafter net expenditure is forecast to grow by about 1 percent per year through 1996/97. Rates income follows a similar pattern. Debt is budgeted to be $140 million by June 1995 or $166 million if the proposed investment in commercial property is debt-financed. Forecasts of net debt over the next three years are not provided other than in graphical form. The graph of forecast debt shows a significant increase in debt in 1995/96 to finance additional but unspecified project expenditure. Debt is forecast to reach a peak of around $170 million in 1997/98 and thereafter to gradually decline until 2013 when current levels will be restored. It is unclear whether investment in commercial property has been taken into account beyond June 1995.

2.5 The 1994/95 plan indicates a slackening of efforts to achieve improved efficiencies. A 5 percent increase in rates revenue is proposed for 1994/95. This increase is on top of an already high level of rates. While it is intended to be a 'one-off' adjustment, the inadequate focus on improving efficiencies and rising debt levels casts doubt on the sustainability of this undertaking.

3.0 Core Functions

3.1 Although the Council examined its functions in 1990 and 1991, and again in the course of preparing its strategic plan, it does not appear to have consistently applied sound principles or taken a sufficiently rigorous approach. The Council's role should be defined according to generally accepted criteria for government intervention in the economy. These would suggest a role for the Council in organising services that exhibit significant features of local public goods, administering programmes delegated by central government and performing local regulatory functions.

3.2 Local public goods or services are ones that have two basic properties. First, it is impossible to exclude individuals from enjoying the benefits of the goods or services (the non-excludability property). Secondly, it is undesirable to exclude individuals from enjoying the benefits of the goods or services as the enjoyment of them by one person does not detract from that of other people (the non-rivalrous property). Services such as street lighting, roading, sewerage, refuse disposal and parks and reserves come closest to exhibiting these properties. While the Council may need to arrange for the provision of local public goods and services, it does not follow that such goods and services should necessarily be provided by the Council or be funded from rates.

3.3 The NZBR does not accept that the Council has a valid role in redistributing income among its residents beyond the administration of any central government programmes. The redistribution of income is a central government role.

3.4 The Council should define its role in the light of these principles and eliminate those services that are inconsistent with its future direction. The provision of private goods and services such as involvement in commercial property development, parking buildings, aspects of city promotions and rental housing (with the possible exception of limited emergency housing) go well beyond the legitimate role of the Council.

4.0 Expenditure Reductions and Asset Sales

4.1 The 1994/95 plan places too much emphasis on raising revenue and devotes insufficient attention to expenditure and asset reductions aimed at refocusing on core activities and improving efficiency. Asset and expenditure reductions should enable debt and rates to be reduced.

4.2 In its strategic plan, the Council indicated its intention to purchase downtown properties "as appropriate to ensure buildings are used and developed in a manner consistent with the revitalised inner City and Harbour Edge developments". In addition, the annual plan indicates the intention of the Council to develop a Symonds St (ex- Brierley) site, to continue the South East Industrial Area redevelopment and to commence construction of a new bus/rail terminal at Britomart.

4.3 We believe the Council should sell its interests in investment property, including its involvement in Harbour Edge and Downtown properties. There are no valid grounds for investment property to be owned by the Council or for it operating as a property developer. The community's interest would be best served if ownership of commercial property passed to those individuals and firms that are likely to have a comparative advantage in managing and owning property.

4.4 International studies show conclusively that private ownership is more efficient than public ownership and governments of all persuasions in many countries are exiting commercial activities. Residents should not be required to face the risk of rate increases to finance involuntary investments in property or other commercial activities. The Council's involvement in commercial property development has the potential to conflict with its delegated regulatory functions under the Resource Management Act.

4.5 For similar reasons, the Council should sell its interests in car parking buildings. The Council does not need to provide off-street parking facilities. The ownership and operation of parking buildings are private activities. The Council's charges are generally lower than those of its private competitors, suggesting that ratepayers are subsidising central city parking. The Council's activities crowd out private provision. There are no justifiable grounds for the Council's involvement.

4.6 The following additional expenditure and asset reductions are proposed:

- sell the Council's rental housing stock. The provision of housing is a private good. The private market is capable of providing housing for the vast majority of the community and would do so if the market were not distorted by producers that are not subject to normal commercial disciplines. The government has recognised this in introducing the accommodation supplement in place of the provision of subsidised rental housing. The benefits of subsidised Council rents can be expected to have accrued to tenants who are not among those in most need. Substantial efficiency gains would arise from the introduction of commercial disciplines through private sector ownership;

- privatise 'contract services' and 'fleet services' in conjunction with a greater use of contracting for services to encourage efficiency and to reduce costs;

- corporatise water and sewerage services within the city. Water is high on the agenda of Auckland City and the Auckland region. In the Auckland region, the actions of each council affect those of nearby councils. There is scope for a more commercial approach to the provision of water and sewerage services within the region. Water and sewerage services should be corporatised as a first step in working toward more efficient provision of these services within Auckland city. Supplementary proposals on water and sewerage services are listed below;

- undertake a close review of services. The *Management* survey reports the Council is second only to Wellington in its spending per head of population on social and cultural services - around double that spent by Hamilton, Porirua and Christchurch. Auckland is fourth highest in its total per capita spending on services;

- achieve greater operating efficiencies. The Council provided for $3.5 million in 'further savings' in 1993/94, although no savings are budgeted for the 1994/95 plan. The emphasis on improving efficiencies is inadequate and indicates a slackening in the commitment to containing costs. The Council should set a meaningful efficiency target of at least 5 to 10 percent a year for the next three years and beyond;

- reduce staff. Information on the number of staff and personnel costs is not provided in the plan but could be expected to be one of the Council's largest input costs. Staff reductions should be achievable, especially if the Council focuses on its core roles;

- set pay and conditions at levels necessary to recruit and retain staff. Terms and conditions of employment should be set at a level which enables staff of an acceptable quality and number to be recruited and retained. In the present market this may mean that pay for some employees can be reduced;

- scrap subsidies for city promotions and city development/major projects. A subsidy to one firm is a tax on another. There are no large benefits flowing to the wider community that justify the proposed subsidies. 'Enterprise Auckland' purports to encourage "local purchasing, import substitution and investment in Auckland". This is an inappropriate activity for the Council as there are no valid grounds for such interventions. There is no justification for the Council to provide a vehicle testing service to the public or to operate a travel agency business through the Auckland Visitor Centre. Other services with a commercial aspect should be scaled back and provided on a full cost recovery basis or sold;

- investigate ways to increase revenue and reduce costs in respect of the Aotea Centre, including leasing or selling the facility. The NZBR notes the intention of the Council to make greater use of contracted services to reduce the level of subsidy required from the Council. The centre is still expected to be subsidised to the tune of $5.2 million from rates, however. This indicates that the centre is a very poor investment. It competes unfairly with private facilities. If retained, the centre should become self-funding as soon as possible;

- sell the Council's holding in Auckland International Airport Ltd. This is a commercial venture involving business risk. There are worldwide moves to privatise airports, including most recently by the Labour government in Australia;

- reduce capital expenditure in non-core areas. It is of concern, for example, that the Council appears about to embark on a major redevelopment of ferry, bus and rail terminals at the Harbour Edge with little information in the plan on the costs and benefits of the plans, such as expected net costs per commuter. There are ample local and international examples of such schemes being poor investments for ratepayers, such as the multi-million dollar rail/bus interchange in Lower Hutt; and

- review the Council's holdings and use of functional property with a view to reducing its cost to ratepayers.

5.0 Revenue

User Charges

5.1 The costs of providing a few of the Council's services are recovered through user charges. The most notable example is water supply. The strategic plan states that there is limited scope to raise income through user charges. The NZBR considers that it is possible to strike a better balance between those who use the Council's services and those who pay. Higher user charges should not be used to expand the Council's activities, however. They are already excessive. The NZBR also accepts that it is not feasible to charge for some services, not solely because they exhibit public good characteristics, but also because the costs of charging would be excessive. Street lighting, footpaths and roading are examples.

5.2 The NZBR has reservations concerning the Council's policy of taking account of customers' ability to pay as well as the benefits derived from services. The Council may decide to provide some social services where such an approach is acceptable. For most of its services, however, the ability to pay principle is inappropriate. The Council is not in a good position to judge an individual's ability to pay. Central government, which has access to considerably more information on individuals than local government (for example, through the tax system), has encountered difficulties in applying similar principles. Moreover, the NZBR believes that the redistribution of income, which is at the heart of an ability to pay approach, should be a function of central government rather than local government.

5.3 In this context, consideration should be given to placing greater reliance on user charges than rates wherever possible. We recommend:

- examining the recovery of sewerage costs on the basis of water usage, since the two are closely related;

- ensuring that the full costs of recreational activities of a class that are also provided by the private sector are recovered, including an appropriate return on investment. An example is fitness centres. As noted above, the Council should scale back its involvement in commercial activities. If retained, such activities should be corporatised and no subsidies should apply. A greater contribution to the costs of providing dedicated sporting facilities should be sought from the organisations concerned; and

- a review of user charges for amenities such as libraries and sports facilities. Library fees for the Central Library are budgeted to cover less than 10 percent of the gross cost of $9.8 million in 1994/95. The high level of subsidisation of such services represents a transfer from ratepayers who do not make extensive use of such facilities to those who do. There would seem to be scope for greater reliance on user charges.

Rating Policies

5.4 The strategic plan indicates an intention to retain the differential between CBD and residential rates at current levels and this is reflected in the annual plan. The differential is argued as being appropriate on the grounds that:

- it reflects the benefits received by non-residential ratepayers;

- is reflects the ability of ratepayers to pay;

- it ensures that non-residents who visit the city make a contribution towards Council-provided services through the rates differential incorporated in commercial prices; and

- special costs are involved in running particular localities, such as the city centre, which should progressively be reflected in separate rates.

5.5 The may be valid grounds for a differential rate based on the costs of supplying essential services to particular classes of ratepayers where user charges are inappropriate. Beyond this, there are no grounds for charging a differential rate. The present differentials are unlikely to be justified by the specified differences in costs. The other grounds cited for rate differentials are invalid:

- since most commercial activities can take place just as readily outside highly taxed localities, rate differentials are unlikely to be reflected in prices for goods and services. Instead, the rate differential would fall on suppliers of services in highly taxed areas;
- the rate differential could have a significant effect on land uses and property values; and
- ability to pay is not an appropriate criteria for setting rates, as noted above.

5.6 An excessive rate differential may discourage the location of businesses in central Auckland. The setting aside of $1 million from rates to be spent on the CBD 'Heart of City' organisation is an inappropriate response.

5.7 Efficiency requires that the rate burden be allocated appropriately between and within the business and household sectors. For the reasons outlined above, businesses currently bear an excessive share of the rates burden. A firm programme of rebalancing over the next five years is recommended.

6.0 Accountability

6.1 The Council has stated in its strategic plan that it will be accountable for the use of resources and demonstrate value for money. To achieve these goals, adequate and comprehensive information on the Council's activities needs to be made available. The Council is to be commended on steps it has already taken in improving information and accountability, including the publication of its strategic plan.

6.2 In a recently released report on the financial condition of local authorities, the Controller and Auditor General commented that the most serious weakness was a lack of reliable information on infrastructural assets. Most councils do not have adequate knowledge of the condition of assets such as sewerage and water systems, and few councils have formal procedures to monitor and manage these assets. The report concluded that "we do not know if councils are maintaining assets to the level necessary for long-term service delivery". Unfortunately, the annual plan does not provide sufficient information to ascertain whether these criticisms apply currently to Auckland City.

6.3 Monitoring of the Council's performance in meeting its objectives would be facilitated if the the Council made fuller information available in its future annual plans on:

- its future capital works programme (e.g. for projects listed under major activities for the next five years);
- three-yearly projections of revenue, expenditure and debt. Forecast levels of debt beyond 1994/95 were provided in graphical form only;
- the Council's interests in commercial activities and their financial performance. This includes the Council's interests in property ventures and Auckland International Airport Ltd. The Council cited commercial reasons for providing limited information on its property dealings in its 1994/95 plan. A number of other businesses, such as

listed companies, provide more information than that provided by the Council without prejudicing their commercial position. If the Council is to retain its involvement in commercial activities, accountability requires levels of disclosure at least equivalent to listed companies;

- the allocation of direct and indirect costs (including administration and capital charges) to each major activity or output; and

- its broader financial management policy. This would be aided by setting appropriate financial benchmarks. The strategic plan notes that the Council must determine the optimum levels of debt because there are no national or international guidelines on the subject. The Council says it will adopt a conservative approach to borrowing. While there may be debate about appropriate benchmarks, they should be specified since this would assist the monitoring of the Council's financial policies. Christchurch City has adopted financial benchmarks within which it intends to perform.

6.4 The disclosure suggestions outlined above have been adopted by Christchurch City in its 1994/95 Annual Plan which, in our judgment, provides better information than the plans of Auckland or Wellington.

6.5 Auckland City and other councils have made a start in specifying performance measures. These need further development if they are to achieve their goal. We recommend that the Council should also consider adopting a framework for financial management along the lines of the Fiscal Responsibility Bill. The essence of this measure is the establishment of sound financial criteria, the nomination of explicit financial goals and the provision of regular information to the public. This will enhance the ability of the community to monitor financial trends and hold elected representatives accountable for their decisions.

7.0 Conclusions

7.1 The main conclusions that arise from the NZBR's review of Auckland City's 1994/95 plan are listed below:

- the need for increased efficiency in local government is now generally acknowledged;

- spending on low priority activities and excessive rates will act as brake on growth in incomes and employment in Auckland City;

- over the last few years, the Council took worthwhile steps aimed at putting its financial affairs on a more prudent footing but further action is required to achieve a desirable position;

- excessive attention has been given to raising revenue relative to expenditure reductions. Insufficient attention has been given to refocusing on the core functions of the Council;

- the Council should define its role according to accepted principles relating to the government role in the economy and eliminate those services which are inconsistent with its future direction;

- the Council should sell its interests in investment property, car parking buildings, most rental housing stock and Auckland International Airport Ltd. The proceeds should be applied to debt reduction;

- a number of activities such as contract services and fleet services should be privatised. The Council should make a greater use of contracting for services to encourage efficiency and to reduce costs;

- the Council should undertake a critical review of its services with a view to achieving greater operating efficiencies. A meaningful efficiency target of the order of at least 5 to 10 percent a year should be adopted;

- the Council should reduce staff and set pay and conditions at levels necessary to recruit and retain staff;

- subsidies for most city promotion activities should be scrapped;

- planned capital expenditure in non-core areas, such as the Harbour Edge Development, should be reduced;

- there should be a better balance between those who use the Council's services and those who pay. Higher user charges should not be used to expand the Council's activities;

- the NZBR does not consider that ability to pay principles should generally be applied to the setting of local government charges (as opposed to the design of central government tax policy, where they are clearly relevant);

- excessive rates are imposed on businesses relative to households. A firm programme to rebalance the rate differential is recommended;

- greater disclosure of financial and other information would enhance accountability; and

- the NZBR is strongly opposed to any increase in rates in 1994/95 or in subsequent years. There is ample opportunity to reduce expenditure.

7.2 The adoption of the above proposals would contribute to a more fiscally attractive environment for residents and firms and would encourage sustainable growth in incomes and employment. These are the only sure means of advancing the welfare of the entire community.

SUBMISSION BY THE
NEW ZEALAND BUSINESS ROUNDTABLE

REVIEW OF THE NEW ZEALAND TRADE DEVELOPMENT BOARD

MAY 1994

REVIEW OF THE NEW ZEALAND TRADE DEVELOPMENT BOARD (TRADENZ)

1.0 Introduction

1.1 The New Zealand Business Roundtable (NZBR) welcomes the opportunity to make a submission to the Tradenz Review Committee. Consistent with the need for careful scrutiny of the value of all public sector activities, it believes the provision for a review in terms of Section 11 of the New Zealand Trade Development Act 1988 was sound and that if Tradenz is retained provision should be made for future reviews.

1.2 The material in this submission is drawn in part from information provided by NZBR member companies and discussions with other organisations which have had dealings with Tradenz. It also considers the activities of Tradenz in terms of an economic analysis of its role and the principles which have motivated recent government economic policy and public sector management.

1.3 Caution needs to be exercised in drawing on the experience of individual organisations with Tradenz. This is inevitably limited in scope and cannot be taken as representative. Moreover, many firms are beneficiaries of government assistance from Tradenz and may support it for that reason. However, the relevant perspective must be the interests of the overall economy, including those of taxpayers (including other firms) who pay for that assistance.

1.4 The research which we have been able to undertake does not enable us to provide overall "views on the performance" of Tradenz. Some NZBR member companies have had very positive experiences in working with Tradenz and its overseas representatives. We believe Tradenz or a comparable organisation has a useful role to play in facilitating trade in situations where diplomatic relationships are difficult (e.g. Taiwan) or where dealings with state agencies which prefer to deal with other state agencies are important (e.g. China). In this submission we concentrate on perceived areas of weakness and activities which seem dubious on economic grounds. We identify activities which we believe the Committee should investigate in more depth to determine whether they are justifiable functions and/or represent value for money.

2.0 General Perspectives

2.1 The Tradenz budget is currently of the order of $50 million a year, a very substantial sum. Most of it is financed from taxation, and therefore represents resources which are forgone by the private sector. A recent study published by the NZBR, *The Marginal Costs of Taxation in New Zealand*, finds that the deadweight costs of taxation in New Zealand are high, ranging from around 14 percent in the case of consumption tax to 18 percent in the case of labour income tax. This means that at the margin a government project needs to yield a benefit of $1.14 - $1.18 for every dollar of expenditure or, alternatively, that a comparable benefit is available for every dollar of tax reduction. The Committee needs to consider whether outlays by Tradenz are yielding such benefits or whether the community would be better off from reductions in Tradenz spending and associated reductions in taxation.

2.2 There needs to be an explicit justification for any government activity. In that regard, the current statutory function of Tradenz, to foster foreign exchange earnings, presents some difficulties. On its own, it is not a sensible economic objective; for example, if exports by a particular industry were reliant on government assistance they would be unlikely to represent a wise use of resources from a community standpoint. Moreover, export earnings are no more meritorious than savings in foreign exchange achieved by import substitution or indeed than income from production for the domestic market. What is important is that all New Zealand's resources are employed in an economically efficient way in order to maximise national income.

2.3 The focus on foreign exchange earnings dates from a period in which the New Zealand economy was uncompetitive and was frequently in deficit on its balance of payments. To offset high domestic costs, exports were targeted with a number of forms of government assistance, including those channelled through the organisations which preceded Tradenz. Recent economic reforms, however, have greatly improved New Zealand's international competitiveness. Major contributing factors have been reductions in protection, the low inflation environment created by the Reserve Bank Act, stronger fiscal discipline which has taken pressure off financial markets and the exchange rate, the Employment Contracts Act, and reforms to state enterprises, ports and other domestic industries. The improvements in competitiveness have led to strong export growth. The necessity for all the activities of Tradenz needs to be re-evaluated in this light, bearing in mind that it can only be expected to have a marginal influence on New Zealand's export performance relative to more fundamental economic factors.

2.4 Accordingly we suggest that the Committee needs to consider carefully whether there remains a rationale for Tradenz and, if so, to formulate it in economically meaningful terms since a role of simply increasing foreign exchange earnings is clearly not valid. In its search for a rationale, the Committee is likely to find itself examining possible forms of 'market failure' in exporting, whereby national income would not be maximised if the private sector were left to its own devices. These will probably come down to contentions that some firms will not invest in market development at the appropriate levels because they cannot capture all the benefits of such investment, and that firms will 'free ride' on the efforts of others. Alternatively it may be argued that there are 'infant market' arguments for government assistance, along the lines of former 'infant industry' arguments for protection. In considering these arguments, a number of factors need to be borne in mind:

(i) There are spillover and free rider effects in all economic activities. For government intervention to be justified in any particular case it needs to be shown that they are particularly large, and that the benefits of intervention exceed the costs.

(ii) Taxpayer-funded assistance typically reduces the need for private sector effort. Subsidised market development assistance will, to an unknown extent, discourage firms from developing their own expertise in export market development. There should be a detailed analysis of this disincentive effect.

(iii) Similarly, there are many private firms engaged in providing market development services to exporters which are in actual or potential competition with a government agency. To the extent that subsidised government activities displace more efficient private ones, New Zealand is worse off.

(iv) It is very difficult to monitor the effectiveness of government market development and trade promotion activities, particularly when these are not provided on a commercial basis, as is currently the case. This suggests caution especially in areas where there are clear private sector substitutes.

(v) If any weight is given to 'infant market' considerations, this suggests that assistance should not be targeted to markets that are familiar or easy to penetrate.

2.5 Even if there may be a theoretical case for government intervention on market failure grounds, consideration needs to be given to the practical issues that arise in dealing with the problem. It is not easy for a government agency to attract people with high level marketing or other relevant commercial skills. Because there are few rewards for good performance and weak sanctions for poor performance, resources may be wasted. Political pressures of one kind or another may influence the allocation of funds in a way that reflects the interests of specific firms or industries rather than the general community. The Committee needs to determine whether those forms of 'government failure' outweigh any positive benefits from government intervention in the case of Tradenz.

2.6 The foregoing analysis points up the following issues for examination by the Committee.

(i) The present structure of Tradenz lacks clear performance measures and forms of accountability. The Committee should examine whether this problem could be overcome by changes to its organisational form. One possibility would be for the government role to be viewed as that of a purchaser of trade promotion and market development services. This purchasing function could be separated from the provider role and placed with the Ministry of Foreign Affairs and Trade or a separate agency. Contracts for the provision of services could be negotiated with Tradenz or any competing supplier. This would provide a competitive test of Tradenz's performance and reduce the risk of crowding out more efficient private sector substitutes.

(ii) If a case for retaining Tradenz is established, we believe more of its activities should be charged for on a commercial basis. This was the original intention but it has not been implemented to any significant extent. There is no reason, for example, why firms which find the services of trade commissioners valuable should not pay for them. This would improve incentives both for trade representatives (to perform well) and for firms (by testing the true value of services in terms of firms' willingness to pay).

(iii) The offshore resources of Tradenz should be concentrated on markets that are new and/or difficult for New Zealand exporters. We see little or no justification for Tradenz involvement in Australia, the United States or the United Kingdom, for example, unless this is on a fully commercial basis. The absence of language problems, the existence of numerous commercial links and the capability of modern communications technology all facilitate market research and development in these markets. For all practical purposes Australia is now part of the domestic market and should be treated as such. If there is any case for residual involvement in these markets on anything other than a commercial basis it should be limited to small, first-time exporters not large or established firms.

3.0 Specific Aspects of Tradenz Performance

3.1 Lavish expenditure

There is a widespread private sector perception that Tradenz wastes money. One example is the Porter project which ran massively over budget yet no one in Tradenz appears to have been held accountable for it. Another is the hiring of expensive consultants who would not be regarded by private organisations as representing value for money. A third is lavish expenditure on glossy publications such as *Stretching for Growth*. This contains little information that is not available elsewhere and nothing that is new to participants in specific industries. We believe the private sector should be expected to take more ownership of many Tradenz projects by fronting up with funds, otherwise they should not proceed. We also suspect some of the salaries paid to Tradenz staff may be out of line with market ranges for staff with comparable capabilities. Because of the significance of personnel expenditure, we suggest this is an area which the Committee should investigate in some detail.

3.2 The New Zealand Way

This appears to be another expensive project which we believe the Committee should closely scrutinise. We are dubious about the concept, which is based on the view that there is value in a general New Zealand brand. However, we doubt whether New Zealand is incorrectly perceived offshore or that the market position of exporters (whose individual performance is what matters to customers) is significantly affected by a New Zealand logo. We suggest the Committee should investigate the costs of this project to date, the likelihood of the company meeting its operating costs and making a return on capital, and the reality of the claimed benefits of the project.

3.3 Policy and Strategic Development

Tradenz is not equipped with analytical skills to deal with policy issues and its contributions in this area have been poor. Examples include the report *A Goal for New Zealand* which was a vacuous document, the Porter report which added little to the policy debate and contained several unsound conclusions, and a number of issues on which Tradenz has pushed for government intervention on poorly analysed grounds e.g. offshore banking.

Running through much of Tradenz's thinking in this area is a 'New Zealand Incorporated' view of the economy which is at odds with current government policy. This has moved away from forms of industry planning to an emphasis on creating an environment in which the decisions taken by firms in their own interests will also maximise national interests. The promotion or imposition of a collective approach risks stifling diversity and innovation among firms. One manifestation of Tradenz's thinking is its support at a staff level for current producer board structures which conflicts with the advice of government agencies with greater expertise in this field including MAF, Commerce and Treasury. Our own contacts on this issue with Tradenz staff confirm that their analytical skills are not of a high professional standard. Regardless of the view that is taken on this issue, policy and so-called 'strategic' development is not a core function of Tradenz and we consider any such activities should be dropped.

3.4 Composition of Board

We believe the Tradenz board should be comprised primarily of people with export market development and other commercial skills. They should also understand the determinants of international competitiveness and the relevance of the current policy framework, as opposed to a 'New Zealand Incorporated' approach. It is not clear that these criteria for appointment have always been met. Because of the importance of board leadership and direction, we suggest the Committee considers the criteria which should apply to board appointments.

3.5 Joint Action Groups

Some JAGs are viewed favourably by private sector observers and regarded as providing value for money. At the same time they can compete with and crowd out private sector initiatives such as the trade groups of the New Zealand Manufacturers Federation. We believe the Committee should carefully examine this problem. It is hard to see why a government agency should, at most, be any more than a catalyst in bringing industry parties together and perhaps provide seed money to do so. If networking is valuable, the demonstration effect of a few initiatives should encourage others. Ongoing activities should be primarily a private sector responsibility. If there is any case for government subsidy, it should perhaps go directly to promotional activities of private sector groups on a contestable basis.

3.6 Overall Tradenz budget

We suggest the Committee reviews the overall Tradenz budget in the light of a review of its specific activities. The combination of wasteful expenditure, a number of grants which seem peripheral to its role, the potential to shed functions, and the scope for introducing commercial charging for services suggest that net funding requirements from the government could be significantly reduced.

4.0 Conclusion

4.1 We believe that given the very different economic and policy environment that has evolved since Tradenz was established, some fundamental questions now need to be asked about its rationale and activities. In the first instance, the goal of increasing foreign exchange earnings is inappropriate and needs to be respecified. There may be an alternative rationale for government intervention in market development, but it is a problematical one and the Committee needs to establish in a systematic way whether the government can do a better job than the private sector left to its own devices. If this point can be established, the range and scale of activities needs to be considered, and we believe there is a strong presumption that these can be cut back and/or charged for on a commercial basis in many cases. There should be some quantitative analysis of whether Tradenz is achieving a rate of return on projects which is commensurate with the opportunity cost of its funds, having regard to the deadweight costs associated with tax financing. Contestability of service provision should be introduced wherever possible.

4.2 In our view, the last review of Tradenz lacked depth and analytical rigour. The issues which the Committee is asked to deal with are not easy to resolve. The Committee should proceed in an independent manner and in this regard the provision of a secretariat by Tradenz is inappropriate. We consider that independent professional resources should be sought by the Committee to undertake properly structured research on priority issues identified in submissions and as a result of its own initial deliberations.

EDUCATION AND THE LABOUR MARKET

NEW ZEALAND ASSOCIATION FOR MIGRATION AND INVESTMENT
ANNUAL CONFERENCE

IMMIGRATION POLICY: TIME FOR A TUNE-UP

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AUCKLAND
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IMMIGRATION POLICY : TIME FOR A TUNE-UP

The July 1994 issue of *North and South* contains a readership poll which gives some interesting insights into where the country is now at. A solid 72 percent of respondents were optimistic for the future. Nine out of ten believe the economy is stable or improving. Eighty percent want present economic policies to continue or to be taken further. Seventy-five percent think the government should use any budget surplus to repay debt. And 72 percent think New Zealand would benefit from more immigrants.

These are healthy findings, and in line with many other surveys which indicate high levels of economic confidence and a belief that New Zealand has at last turned the corner and is on the right track. They are a far cry from the national mood of a few years ago when support for present policies was a highly unpopular stance. Either it was believed they would not work, or if they did that they would benefit only a fortunate few.

Economic theory and research, however, tell us that open, competitive economies are far more successful at raising income levels and sharing the benefits of growth than closed, interventionist economies. 'Communist' China - paradoxical as it may seem - has greater inequality of income than Taiwan or South Korea. As Michael Roemer, a leading contemporary researcher on economic development, has put it:

> ... economic growth is the only mechanism through which the welfare of the poor can be improved in a sustainable way. The fast growing countries of East and South-East Asia are reducing the incidence of poverty at astonishing rates.[1]

Roemer goes on to point out that this is not the result of so-called "trickle-down" economics but is the outcome of sound economic fundamentals and high rates of employment growth in productive industries. New Zealand is experiencing the same phenomenon with the extraordinary rates of employment growth that are occurring in our more flexible labour market. These social benefits far outstrip any that can be produced through welfare transfers - which, of course, are not a significant feature of Asian countries. There appears to be public endorsement of that analysis - 77 percent of the respondents to the *North and South* survey felt there should be less rather than more welfare in New Zealand.

Nevertheless, we cannot be complacent about the state of community understanding of what makes for a successful economy, and immigration is one issue on which the general improvement in economic literacy still has some way to go.

One particularly resistant myth is that the case for immigration is primarily about the economic benefits of a larger population. Thus David Round of Canterbury University questions the assumption that "increased population leads to greater prosperity, employment and economic 'growth'."[2] Similar sentiments frequently appear in letters to the editor columns along the lines that:

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[1] Michael Roemer, "Assessing Aid," *The Economist*, 4 June 1994, p 4.

[2] David Round, "Do we really need immigration to produce growth and prosperity?," *The Press*, 9 June 1994.

> Immigration is about whether the country can sustain the people who want to live here. We must all be mad to be opening the doors without thought to the consequences.[3]

No serious advocate of immigration that I am aware of advocates "opening the doors without thought to the consequences". We have a right to be selective, to expect immigrants to respect New Zealand laws and our cultural and intellectual traditions, and we should avoid the politics of multiculturalism which is corrosive of social cohesion. Nor does anyone I know believe that prosperity is equated with population size. If this were the case, China and India would be the richest countries on earth, a patently absurd proposition. If we simply wanted a larger population, why not just join up with Australia? Would that help our economy? Hardly, especially if the price was the adoption of some of Australia's less satisfactory economic policies. There is no reason why a small economy can't perform as well as a large economy. The relevant market for a small economy is not the domestic market but the world market, which it can tap into provided it is open and competitive.

A related fear concerns effects on natural resources and the environment. This features in the immigration debate in every country. But, as a leading researcher on population and natural resources, writing about the United States, has put it:

> Much of that proposition is demonstrably bunkum. The water and food ingested in the US have been improving in past decades by every reasonable measure of quantity and purity, though the fact is too little known. The air in the US also has been getting less polluted. And over the long run, natural resources have been getting less scarce rather than more scarce, as indicated by the trends in the fundamental economic measure of cost. Additional people do increase resource demand and prices in the short run. But in the longer run, when the system has had a chance to find new sources and substitutes, the result is that resources are typically more available and cheaper than if the temporary shortages had never arisen.[4]

No one is talking about allowing in unlimited numbers, and New Zealand is far from being the number one country of choice for migrants - although, thanks to our better economic performance, we are becoming more attractive. As a practical matter, an annual net intake of even 30-40,000 immigrants a year would not make a great deal of difference to our population over a decade or so, particularly given the slow rate of natural increase.

Another myth which has resurfaced recently, particularly in statements by the Hon Winston Peters, is that immigration makes the problem of unemployment worse. It happens to be the case that until recently there was a net outflow of migrants from New Zealand, and that the small net inflow of the last couple of years has been associated with a fall in unemployment. Thus the facts do not fit Mr Peters' claim particularly well; it could be argued that the pick-up in immigration has helped create jobs and reduce unemployment.

More importantly, there is a large body of economic research to help us on this issue. The main recent New Zealand study on the subject by economists from Victoria University found that an annual net migration of 15,000 per annum "would have a downward effect on the rate of unemployment."[5] Other studies are virtually

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[3] A.E., Glenfield, *The Herald*, 4 June 1994.

[4] Julian L Simon (1989), *The Economic Consequences of Immigration,* Basil Blackwell, p 343.

[5] Jacques Poot, Ganesh Nana and Bryan Philpott (1988), *International Immigration and the New Zealand Economy,* Institute of Policy Studies, pp1-2.

unanimous on this point. Simon notes that no study of the United States has found across-the-board unemployment caused by immigrants, because they create jobs indirectly with their spending and with the businesses they start.[6]

Of course, immigrants do displace local residents in some specific jobs, and may have some negative effects on wages in their own occupations. The evidence suggests these effects are generally small, but the competition is often resisted by special interests. Thus the Auckland School of Medicine and the Medical Association have recently complained that immigrant doctors are competing for jobs with expensively-trained New Zealand medical graduates, with the result that some have left for overseas. What was not pointed out is that other persons are benefiting from lower-priced medical services (and creating other jobs with their additional disposable income) and that a more logical solution to the wastage of taxpayer subsidies would be to charge higher tuition fees as recommended by the Todd task force.

None of the other economic arguments against immigration stands up to scrutiny, if evaluated from the point of view of the overall community rather than the interests of particular groups. On the other hand, there are benefits from immigration which should appeal to some supporters of New Zealand First, in particular the point that immigration reduces the median age of the population, thereby countering 'greying' and declining natural population growth. With the ratio of the working age population to those in retirement projected to fall early next century, immigration of working-age persons could slow this process.

Other positive arguments for immigration as seen by the New Zealand Business Roundtable have been made on past occasions and I don't propose to rehearse them at length here. We have placed emphasis on the long-term potential of immigration to contribute to the internationalisation of the New Zealand economy and the development of linkages with the rest of the world. Immigration does not have a unique role in that process - clearly trade, open capital markets, tourism and communications are also relevant - but it is a powerful reinforcing factor.

From that perspective, immigration enhances the knowhow, the skills and the trading contacts that are essential to New Zealand's economic growth. Many New Zealand companies are succeeding in attracting management talent from overseas which is helping them to cope with global competition and upgrade New Zealand management quality. Over 20 percent of the chief executives currently heading the major companies represented on the New Zealand Business Roundtable were not born in New Zealand.

Immigrants bring new ideas and challenge local ways of doing things. Two examples from the recent television documentary *Instant Kiwis* on Asian immigrants illustrate these points well.

The first concerns attitudes to education. Some New Zealand teenagers were seen commenting on Asian students' education success and their commitment to study:

> I couldn't handle that, eh?" said one. "No social life, no nothing. We're supposed to do 10 hours of homework a week but together (my friend) and I only do three (giggle, giggle). ... But I think New Zealand education doesn't push us hard enough.

Those teenagers had at least learned something from exposure to their Asian peers in the classroom. The lesson is an important one: in the *North and South* survey I referred

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6 Op. cit. p 344.

to earlier, 59 percent considered our state education system to be only adequate or poor.

The second example in the documentary of a challenge to New Zealand ways of doing things concerns producer boards. Asians simply can't make sense of the fact that investors and producers in our main horticultural industries and dairying are not allowed to export their own products. Who can blame them? They have never encountered such commercial practices. More than once in the programme Asian business people spoke of their frustration at not being able to capitalise on their connections in their home countries to expand New Zealand's trade. The enormous asset of the worldwide network of Chinese entrepreneurs, knowing the language and the culture of rapidly-growing markets which we need to penetrate, is being wasted by our self-imposed restrictions.

The programme also threw light on other New Zealand attitudes to immigration, in particular those in the interview on the beach with Dr Ranginui Walker which some reviews and editorials described as "arrogant" and "xenophobic." However, there is a sense in which I can sympathise with Dr Walker and David Round who would "pull the immigration ladder up behind us."[7] Immigration policy should be about the sort of society we want, not just about economic matters. Immigration does involve trade-offs. A preference for Fortress New Zealand should be respected as a legitimate attitude, though it is not one I happen to share. For me, the closed and inward-looking New Zealand economy not only led to economic stagnation and social distress, it also lacked the energy and diversity which caused many to seek more exciting lives elsewhere. I personally think New Zealand is now becoming a much more interesting and attractive place in which to live, work and do business, but others are entitled to the view that it should remain a cultural museum.

I very much doubt, however, whether this is a realistic option, even if it is thought desirable by some. It sits uneasily with the internationalisation of the New Zealand economy and global trends. The next few decades seem likely to see the greatest surge of market-driven economic growth the world has ever known, particularly in Asia. The economic and cultural effects of this phenomenon will be irresistible. In this event Dr Walker's stand on the beach will be like the lesson demonstrated by King Canute. The issue will not be whether we adapt to these trends but how. Forward-looking Maori groups such as Waipareira Corporate are adapting by getting into joint ventures with Asian immigrants. I suspect a readiness to adjust and grasp new opportunities, to become citizens of the world while retaining a New Zealand identity, will be the way of the future for all groups in society.

If the arguments for a liberal approach to immigration are accepted, how should we score current policy? The essence of the changes introduced by the last two governments was to adopt a steady, long-term strategy rather than attempt to fine-tune immigration to the state of the economy or the labour market, to increase annual numbers, to simplify and broaden selection criteria and to upgrade administration. These were positive developments but, as David McLoughlin's recent article has shown, subsequent performance has fallen short on a number of counts.[8]

For a start, the increase in the number of annual arrivals has been relatively modest. Clearly a significant inflow is necessary if immigration is to make a difference. With the more flexible labour market and an economy that is growing and offering more opportunities for entrepreneurial initiative, there is plenty of scope to step up the annual intake. Experience has not demonstrated major problems of adjustment or

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[7] *The Press*, op. cit.

[8] David McLoughlin, "Immigration : Out of Control," *North and South*, May 1994.

assimilation, and increased immigration would help ease any skill shortages that may appear as the economy continues to expand.

The second problem concerns selection criteria. All experience with immigration policy points to the case for taking a broad, lightly-regulated approach. Policy should aim to screen out undesirables such as people with criminal records or major health problems, for example, and tilt towards skilled, young and English-proficient immigrants. Beyond that it should not try to over-reach itself by bureaucratic attempts to 'pick winners'.

The points system for general category immigrants was a step forward, but weaknesses in it are showing up and there are signs that we risk sliding back into detailed administrative rules. For example, too high a weighting appears to be given to academic skills relative to trade skills, and there have recently been suggestions that employers recruiting overseas should have to sign a contract to train unemployed New Zealanders as well. Given the transactions costs involved in overseas recruitment, few employers look overseas for staff unless they have to, and market competition is driving firms to increase training. We should not force convoluted additional requirements on them.

A similar attitude should apply to investment. The idea that immigrants can create an instant Silicon Valley in New Zealand is naive. It is futile to go to great lengths to regulate in favour of 'active' rather than 'passive' investment. What is wrong with immigrants investing in, say, government bonds? One effect is likely to be the freeing up of some capital for equity or debt investments that New Zealanders are better placed to undertake. It takes time to learn about a new business environment. Indeed the real contribution may come from the second generation immigrant who makes good.

Thirdly, there are clearly major problems with the culture and performance of the Immigration Service. These have been well documented and I do not intend to dwell on them. They raise questions of accountability which ought to be pursued. It was pleasing that the general manager of the Immigration Service acknowledged the validity of some of the criticisms in his reply to David McLoughlin's article. His commitment to improved customer satisfaction is welcome and should be monitored.

I believe that with two and a half years' experience with the new immigration policy behind us, a general review of policy rather than the more specific ones the government is undertaking would be timely. A constructive input could be made by the private sector. Experience with both the numbers of immigrants and their quality should be reviewed. Some modification of the points system might be indicated. I would also like to see a thorough examination of the merits of using a price mechanism such as an admission fee (in conjunction with other current programmes) as a device for rationing immigration, along the lines recommended by the Nobel laureate Gary Becker, Julian Simon, Wolfgang Kasper and other economists. The usual objection to this proposal is that it would bias immigration in favour of those with financial resources. Current policy deliberately does this to some extent anyway, and if it were a problem one obvious solution would be to require payment over time on an income-contingent basis along the lines of the student loans scheme. The attractiveness of setting an entry price for a category of general immigrants is that individuals are likely to assess their own economic capacities better than a general points system.

While the role and performance of the Immigration Service should come under scrutiny in such a review, so should the role and performance of those in the private sector providing immigration services of one sort or another. David Lange is one person who has directed some sharp and perhaps well-justified criticism at the performance of some immigration consultants. In recent years the private sector has been arguing that the government and its agencies should draw back from things they can't do well; the counterpart to that proposition is that the private sector must shoulder its responsibilities. In immigration there is, or should be, a natural partnership between the private sector as promoters of New Zealand and suppliers of services to immigrants before and after arrival, and the government as final arbiter of who may enter. There seems plenty of scope for making this partnership work better. Should the NZAMI become a more professional body and play a lead role in this regard?

Finally, I believe it is incumbent on the private sector to help make the case for immigration, to respond to ill-informed criticisms and to deal with sensitive issues as they arise. These cannot all be left to the politicians. Dr Manying Ip deserved credit for helping to defuse some tension over Asian immigration last year and Aussie Malcolm made a very sensible contribution during the controversy over a recent South African case. Comments like those of Winston Peters need to be answered, not in a political way but by providing facts and arguments.

Most New Zealanders are not anti-immigration or xenophobic. However, some taxpayer-funded academics like David Round disdain people who have to make a living by providing services that people are willing to pay for: he talks about "members of the lucrative little industry of immigration consultants."[9] If you want to maintain the integrity of a sound immigration policy, and to contribute to the process of New Zealand rejecting isolationism and embracing openness, you will have to stand up and be counted in these debates.

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[9] Op. cit.

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SKILL DEVELOPMENT AND INDUSTRY TRAINING

TEN MYTHS ABOUT TRAINING

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TEN MYTHS ABOUT TRAINING

Introduction

The central planning mentality is still alive and well in education. Soviet planners used to set targets and factory quotas expressed in terms of millions of tons of salt or steel. Education planners tell us we need more education and training, and set targets for things like participation rates at different educational levels and graduate numbers in particular disciplines. The consultation document *Education for the 21st Century* is full of such forms of educational Stalinism. Unions tell us that apprenticeship numbers should be higher and some politicians want to impose levies to force employers to provide more training.

The education and training field is strewn with hoary chestnuts. Unsubstantiated and false assertions abound. I want to deal with some of these myths and to suggest we need to shift the debate away from quantities and targets and to focus on incentives and the training environment. My remarks are mainly directed to post-compulsory education, particularly workplace training.

Myth # 1 New Zealand is under-investing in training

This is a typical central planner's statement. It assumes thousands of New Zealanders are behaving irrationally. It is also completely vacuous. One would assume that those making it have some knowledge of how much training is done and how much should be done. But no such knowledge exists. There is no agreed or obvious definition of training, no definition of trainers and no one knows how many trainers there are. No one has any idea of the magnitude of on-the-job training or other forms of informal training. And under-investing relative to what? To other countries, to past levels of training or to some notion of the optimal level of training in the economy?

If it is asserted that the level of training is not optimal, how do we know we are under-investing? Could it not just as easily be the case, to borrow from the title of a recent British study, that we are *Training too Much?*[1] Trainers like to point out that training is an investment and not a cost. Clearly it is possible to over-invest or make the wrong type of investment in training just as it is possible to make mistakes in other investment decisions. More is not necessarily better. It all depends on the investment returns.

Myth # 2 Unskilled jobs are disappearing

Are they? *The Economist* reports that America's economy has one and a half times more janitors than investment bankers, stockbrokers, lawyers, accountants and computer programmers put together.[2] Is it really more difficult to maintain a car than to maintain a horse? Children who have spent time playing video games can adapt rapidly to computerised manufacturing processes. The fast-growing tourism and personal services industries are generating many rewarding jobs that do not require high-level paper qualifications. A 1990 study by the National Centre on Education and the Economy reckoned that one-third of all jobs needed training but not a four-year

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1 J R Shackleton (1992), *Training Too Much? A Sceptical Look at the Economics of Skill Provision in the UK,* Institute of Economic Affairs.

2 Training in America,' *The Economist,* 15 January 1994, p35.

college education; another third did not require even a full high school education.[3] *The Economist* also reported growing evidence that there are not enough skilled jobs for today's number of skilled workers.

None of this denies the case for training. Higher skilled jobs are usually more interesting and better paid than lower skilled jobs. There is little point in competing at the bottom end of the labour market if there are better alternatives. The point is simply that the bottom end hasn't disappeared.

Myth # 3 Education and training are the basis of economic growth

It is difficult to find any positive correlation between the resources a country devotes to education and training and its rate of economic growth. Using participation rates of 16 to 18-year-olds in full-time or part-time education and training for 13 OECD countries, Shackleton found a *negative* (but statistically insignificant) correlation between participation and growth performance over the decade 1979-89.[4] An EPAC paper by Leo Maglen of Monash University based on a range of Australian and international data found that for society as a whole, expanding post-compulsory education has no direct impact on productivity and economic growth. If it outstrips the growth in jobs normally associated with that level of education, it merely results in 'credentials creep' - an increase in the educational standard required.[5] Work by Maglen, the World Bank and other researchers is suggesting that investing public money in higher education makes less sense in terms of equity and efficiency than investing it in primary and secondary education where returns are higher.

Myth # 4 Training is the answer to unemployment

A simple example will demonstrate the fallacy in this argument. Twenty years ago Hong Kong had full employment at low skill levels and low average rates of pay. Today it has full employment at much higher skill levels and much higher average rates of pay. Clearly employment is not about skill levels *per se* but about pay rates relative to productivity. Essentially, education and training affects the *quality* of the labour force and hence the pay rates that more productive workers can obtain; it does not affect primarily the *employability* of a given labour force. An efficient and flexible education and training system can facilitate retraining and labour mobility, and hence help deal with an unemployment problem However, tax-financed training may also destroy private sector jobs as resources and spending power in the private sector are siphoned off. Often the best form of training, particularly for low-skilled young people, is not formal training but on-the-job training at a low initial wage.

Myth # 5 New Zealand is facing a skill crisis

"It is not too alarmist to speak of a potential skills crisis," Mike Smith of the Engineers' Union wrote in an article recently.[6] The idea that the economy will run into a skills bottleneck and that this justifies government intervention in the labour market seems

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3 Ibid p35.

4 Op. cit, p17.

5 L Maglen (1992), *Assessing the Economic Value of Education Expansion: a Preliminary Review of the Issues, Arguments and Evidence,* Background paper for the Economic Planning Advisory Council, Centre for the Economics of Education, Monash, March.

6 *The Dominion*, 26 January 1994.

to have become the latest union criticism of the Employment Contracts Act now that other criticisms have turned out to be unfounded.

The skills crisis myth has been demolished by Professor Ivan Snook who points out that the 1993 OECD report on New Zealand found that the availability of skilled labour was high by international standards, that there was no evidence of increasing skill mismatches over the 1980s, and that over the last two years unemployment had risen more rapidly among those with higher qualifications than the unqualified.[7]

Similarly unions have lamented a drop in apprenticeship numbers in recent years, neglecting the fact that apprenticeship has been a minor form of training (although one subject to a large measure of union control). Moreover, inflexible, time-based forms of apprenticeship have been in decline worldwide. For example, in the 25 years from 1964 to 1989, the numbers of apprentices in manufacturing in the United Kingdom fell from nearly a quarter of a million to just over 50,000.[8] Today the trend is towards multi-skilling. However, with the pick-up in the economy, even traditional apprenticeship numbers are growing rapidly without government intervention. For example, Trevor Allsebrook of the Master Builders Federation was recently quoted as saying:

> In the past year, the number of [new] apprentices trained nationally has grown by 600 to 1700. We are now faced with the embarrassing situation of builders literally lining up to take on new apprentices as they emerge from their pre-trade courses at polytech.[9]

This is a source of embarrassment that I, for one, am happy to live with. Similarly David Moloney of Interlock was recently reported as saying that his firm has no problem finding skilled workers and has continued to take on apprentices; they start at a low rate of pay which improves steadily as a planned series of skills qualifications are achieved.[10] But the dinosaurs are not only on the union side. As Pauline Swain has noted:

> The dinosaurs in business are those employers who sit wringing their hands about a looming skills crisis, expecting waves of pattern-makers, software specialists, fitters, turners, electricians, engineers, or whatever, to roll off some education production line somewhere that is someone else's responsibility.[11]

Myth # 6 Training is devalued in a market economy

"Corporatisation and privatisation, with a strong owner demand for return on assets and share-price maximisation, have meant that training budgets have been slashed, if not eliminated," writes Mike Smith.[12] No evidence is produced in support of this assertion which is patently incorrect. While firms under pressure may have cut back on training and other expenses during the recession, the more competitive economy and freer labour market are clearly powerful factors driving firms to increase training.

7 Ivan Snook, 'Skills Crisis Myth Persists', *The Evening Post*, 28 February 1994.

8 Shackleton op. cit. p27.

9 'Building hits 18-month high,' *The Dominion*, 22 March 1994.

10 Pauline Swain, 'How to hire and keep skilled workers,' *The Dominion*, 28 January 1994.

11 Ibid.

12 Op. cit.

Telecom, for example, has been reported as budgeting more than $10 million for training this year, with one programme involving 20 hours of training for every staff member.[13] A recent NZIER study found that 59 percent of employers planned to increase in-house training and half planned to step up other training. Moreover, such statistics fail to pick up many of the most important training experiences, particularly in small firms, such as co-workers 'sitting next to Nelly' and keeping their eyes and ears open. The incentives to acquire skills are much stronger in a labour market characterised by enterprise contracts rather than national awards as firms are better able to recognise and reward productivity. Competition is forcing firms to invest in training to upgrade skill levels and to increase wages for skilled workers as the labour market tightens. These trends are positive for workers, but not necessarily for union officials who have sought to persuade workers that higher pay results from unionisation and 'collective action.'

Myth # 7 Firms are discouraged from training because others 'free ride' on their efforts

Typically, as *The Economist* has pointed out, the argument goes as follows.[14] When a firm pays for workers to be trained, the trainees become more productive not only in their present employment but also in any number of different jobs, with different employers. If a trained worker is 'poached' by another firm, the employer that paid for the training has subsidised the training costs of a competitor. The fact that the firm cannot capture the benefits of its spending is a kind of market failure, and firms will spend less on training than they otherwise would.

As *The Economist* points out, this argument, despite its impressive pedigree, is wrong. While employers may not directly capture the benefits of their spending on training, the workers who receive the training can. Once equipped with their new skills, they will be paid more than untrained workers, either by their present employer or by some other. So the benefits of training do accrue chiefly to one of the parties to the transaction; they are not sprayed over the economy at large. Provided it is allowed to work, the market's answer is simple: workers undergoing an expensive training will be paid less, for the time being, than the value of their work to the firm.

Under the Employment Contracts Act there is far more scope for employers to enter into contracts with a training component which is beneficial for the employee and the firm. They can be more readily adjusted to compensate for skill acquisition without irrelevant and damaging flow-on effects. As the article cited earlier reported:

> Interlock is not particularly worried about other businesses poaching workers it has trained: "People who are content don't tend to leave for the odd dollar," Mr Maloney says.[15]

Myth # 8 Training levies are needed to force employers to provide training

This proposition is usually based on the free rider argument which, as we have seen, is fallacious. An Employers Federation survey of structured training estimated that employers allocate on average around 2 percent of their payroll to training. If this percentage applied across all industry, total spending on formal on-the-job training

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13 'Economy loosens purse strings,' *The Dominion*, 17 March 1994.

14 'Investing in people,' *The Economist*, 26 March 1994.

15 Op. cit.

would amount to $650 million per annum. Informal training would take the total much higher still. It has been estimated that in the United States workplace training is roughly equivalent in total cost to the entire primary, secondary and higher education systems.[16]

A great deal of evidence suggests that mandated training or government-imposed levies in lieu have little to do with enhancing productivity:

> Luxurious training establishments, visits to conferences in far-flung locations, opportunities for secondments and so on may be a valuable enhancement to the quality of life of employees (including senior management), though they add little to profitability.[17]

An Australian Tax Office study of the Australian Training Guarantee scheme found that up to 30 percent of the funds used for training involved overseas and domestic conferences that were little more than executive and staff holidays. Other firm expenses were reclassified as 'training' to escape the levy. For all these reasons, the Australian scheme became thoroughly discredited and was scrapped (in favour of a training wage) in last month's employment statement *Working Nation*. However, a similar scheme is still being pushed in New Zealand by some union and Labour Party spokespersons and the government is still being lobbied on the issue by some industry groups.

Myth # 9 Employers should pay for tertiary education and training

Both in the case of workplace training and tertiary education, it is sometimes suggested that because businesses benefit from a supply of skilled graduates and trainees, they should pay for the costs of their training.

This reasoning is incorrect. In a world of open capital markets, it is easy to see that New Zealand and international investors and depositors will be demanding a competitive return for their savings, having regard to risk. Under competition they will not secure higher than normal returns in the long run, and all other returns will go to other factors of production, predominantly labour. Hence even if firms initially paid for training (or accident compensation or superannuation levies), they would shift these costs to employees (e.g. through lower pay) in order to achieve normal returns for investors. Thus directly or indirectly, employees pay for their own training which, since the trainees later reap the rewards, is as it should be.

Firms pay now for the costs of the human resources they employ - in the marketplace. Certainly employers 'benefit' from the availability of such resources, but only in the same way that they benefit from the supply of consultancy services, capital, raw materials, transport and other inputs that they combine in producing goods and services. Provided markets are competitive, they will be forced to pay the full economic value for all the resources they use, including skilled labour. Looking at it the other way, employees will be able to command a full economic value for their skills. There is no more of a case for employers subsidising skill training than any other business input.

Although employees are the primary beneficiaries of investment in training, this is not to argue that employers and employees should not negotiate with each other over training. It may well make sense for agreements to be reached on apprenticeships,

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16 A P Carnevale (1986), *The Learning Enterprise*, Training and Development Journal, January.

17 Shackleton op. cit. p36

study leave, bursaries, bonding arrangements, training wages and the like to enable employees to develop their skills. These are matters to be determined by free contracting within a total employment package related to the current and future productivity of the employee. The costs of training will be offset by other elements of the package, such as lower initial wages.

Myth #10 The community should pay for tertiary education and training

"Tertiary education is a community need. Therefore it should be a community cost." This extraordinary proposition was argued by Marion Hobbs of Avondale College on Sunday Supplement on 22 May 1994. Food, housing and clothing are also community needs, arguably even more basic than education. According to Marion Hobbs' criterion, they should all, presumably, be financed by the state.

Following the Watts report, New Zealand university vice-chancellors accepted the principle that the private benefits of higher education should be matched by private contributions. There is strong evidence that tertiary education yields large private benefits. If it provided mostly public benefits, students would have little reason to undertake tertiary studies or care about what courses they took. While others might benefit from their academic accomplishments, they would be no better off. Yet despite this simple logic, vested interest triumphed among the four provider members of the Todd task force, although it was interesting that both they and the student representatives were forced to modify previously held positions.

There is little doubt that the irrefutable arguments for higher student contributions put forward by the four independent members of the task force representing wider community interests will eventually carry the day. George Orwell could have been referring to the self-serving nonsense coming out of the higher education establishment and students' associations when he wrote: "Only an intellectual could believe such stuff; no ordinary man would be so stupid." This seems to be borne out in public commentary such as the following letter to the editor which is an impeccable statement of the case:

> I have a son who hopes to start an engineering degree next year. It looks as though he may have to borrow $20,000 or so. His older brother has started a local delivery service and had to borrow $40,000 to buy a light truck. He does not expect the taxpayer to provide that truck for him. Yet the engineer son, who will one day be earning much more than his older brother, expects the taxpayer to pay for most of his degree, so as to save him having to borrow like his brother has had to.
>
> Also, I remember a few years ago, when students first had to pay 20 percent of their fees, there was a similar outcry from students and staff saying that it was a disaster and that the rolls would drop dramatically. Instead, the reverse has happened and, in spite of the increased charges, enrolments have exploded. It seems that the Todd report is on the right track.[18]

Conclusion

Nothing I have said in this paper questions the value of education. However, I have argued that there is no case for deifying higher education and training or for concluding that central education planners and bureaucrats can do a better job of determining training needs than firms and private individuals. Most of the arguments used to justify government intervention do not stand up to close scrutiny.

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18 *The Press*, 21 May 1994.

Training and skills are not usually ends in themselves, but rather means to greater productivity and better remuneration for workers. Where markets are open to competition, it is workers, not employers, who are the primary beneficiaries of training. Their willingness to invest in training will depend on their expectations of reaping these rewards.

The most effective means by which the government can encourage the kind of training that improves productivity and earnings prospects is to focus not on *outcomes,* but on the *incentives* to employees and employers to invest in training. This means providing an environment in which there are no needless barriers to this kind of investment.

In New Zealand, there have been a number of factors that made investment in training unattractive. The previous structure of labour market legislation made negotiation about training at a workplace or individual level unnecessarily difficult. By levelling pay within and between occupations, it both reduced the potential rewards to investing in training and shut the relatively lowly-skilled out of work experience. Rigid demarcation discouraged such practices as multi-skilling that broaden skills and foster adaptability. Those barriers have now been removed, with evident benefits to firms and their staff. However, barriers such as minimum wage regulation and job-destroying constraints on hiring and firing remain in place.

The performance of our formal higher education institutions also remains a barrier to the goal of becoming a clever country. Visiting academics are often appalled at the standard of teaching and research. Business people consider that many are badly structured and poorly managed and that there is considerable scope for pruning the ivy. There is a strong case for an examination of governance and management practices, which could well yield lower costs and greater value and cushion the impact of higher fees. In addition, training as a barrier to entry may well exist in a number of professions which have long enjoyed a protected status. These areas and the crucial formative stages of education, rather than training - which can be largely left to the market - should be the main concern of policy makers. A recent article in *The Economist* argued that the American system of training was proving superior to the somewhat tarnished German and Japanese models and concluded:

> The most urgent task facing the United States is to reform its highly uneven school system (perhaps through rigorous national exams) rather than to re-invent an apprenticeship system.[19]

This may also be the right conclusion for New Zealand.

19 Training for Jobs, *The Economist,* 12 March 1994.

THE NEW ZEALAND FEDERATION OF SOCIAL STUDIES ASSOCIATIONS
SOCIAL STUDIES CURRICULUM AND CHANGE CONFERENCE '94

THE HUMANITIES IN THE NEW ZEALAND CURRICULUM

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HAMILTON
11 MAY 1994

THE HUMANITIES
IN THE NEW ZEALAND CURRICULUM

Introduction

My dictionary tells me that the word 'humanities' refers to art, literature, philosophy and, especially, the study of ancient Greece and Rome. Accepting this definition, I want to consider three matters:

- first, the importance of the humanities for the school curriculum;
- secondly, the place given to the humanities in the New Zealand Curriculum Framework and in those curriculum statements that have become publicly available; and
- thirdly, since this is a social studies conference, the proposals for a new social studies curriculum with reference to the humanities.

The importance of the humanities for the school curriculum

I would like to suggest four reasons why the humanities should figure prominently in the school curriculum, though many others could be found.

The humanities are our intellectual heritage

First, the humanities provide students with a sense of their intellectual and cultural ancestry. Some peoples, and I think here I can safely include Maori, have a strong sense of belonging to a tribal group, a firm grasp of their genealogy, and strong connections to a particular locality. Latecomers to these shores like myself usually lack this close affinity to a particular group and location. But what we all have in common as New Zealanders, in addition to any strong affiliations to tribe or land, is a rich cultural heritage that goes back thousands of years to Greece, Rome, Israel and to Europe over the last two thousand years.

Jim Traue refers, in his *Ancestors of the Mind*[1], to those who, although unrelated to him by blood, have shaped his beliefs, values, ideas - the things that he holds dear, which identify him as a person. He refers to those who introduced him to those things and those whose ideas, beliefs and values he studied as his "ancestors of the mind". He names some of his teachers from primary school to university who opened his mind to exciting new worlds of books and ideas. He cites the great philosophers of Greece, the jurists and administrators of Rome, the canonical authors of the bible and Christian leaders whose writings have created a rich tradition that "still permeates our society and affects our everyday lives in countless ways." Our ancestors of the mind, Traue points out, come from all languages and civilisations that have left written records - French, German, Russian, English and New Zealanders including Curnow, Rutherford, Sargeson, Frame and Stead, writers, economists, philosophers and scientists. It is, he notes, a democratic culture because it is open to all. Those who wrote the works and those who introduced them to him, his school teachers included, he calls his genealogy, his whakapapa.

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1 Traue, J.E. (1990), *Ancestors of the Mind - a Pakeha Whakapapa*, Gondwanaland Press, Wellington.

I find this approach very helpful. We all need to know where we come from - especially in a mobile, fast-moving society in which tribal, land and family connections are weakening and in which, as it has often been said, the only constant is change. Knowing our ancestors of the mind, our intellectual whakapapa, helps us to cope and survive the changes going on all around us. It is, I suggest, one of the most important things a school can do for young people today. Of course, this also requires the hard mental discipline to acquire the knowledge and skills we need for flexibility in the world of work. But the point here is more of a psychological one - the knowledge of our intellectual antecedents.

Professor Sworder[2] of La Trobe University makes a similar point when he writes of the isolation and loneliness of many of today's young. "They have", he says, "no sense at all of where it is that they came from or what was here before." But he goes on to point out that when they come to study the past with any love or care, that isolation starts to disappear.

> What happens over and over again is a shock of recognition. You study a work from 2000 years ago and suddenly you see that there in that book, in that picture, is the realisation of something that you have felt all your life and have never heard or seen expressed. You discover that you can find out as much or more about yourself from the far distant past as you can from the things that surround you now.

The humanities open up rich new worlds

Secondly, the humanities open up rich new worlds. Hugh Walpole writes[3] of a quite precise moment when the world of books opened up for him. He had been struggling with *Lottie's First Visit to Grandmamma,* two painful lines at a time for months and months, when "suddenly liberation came and [he] paced ahead". He wrote, referring to a particular passage where Lottie is at the seaside during a storm:

> I can remember very vividly indeed that this dramatic passage was a revelation to me. I saw it all so sharply that there was no need for the charming picture. My own personal life was instantly doubled, no passages that I read afterwards, whether in the pages of Marryat or Melville or of Conrad, gave me more vividly the impression of the perils of the sea than did these few lines; the windows were opened and I knew once and for all what reading could do for one.

It is one of the great gifts of good schools, parents and teachers to open up the minds of the young to these new, rich and exciting worlds - as Walpole puts it, to double their personal lives. This is, as I understand it, precisely what Alan Duff is seeking to achieve with his books for Maori children programme - to add depth and breadth to their lives and a good foundation with which to cope with life's challenges.

The world of literature has so much to offer us. Professor Karl Stead,[4] writing of the draft English curriculum, says:

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2 Sworder, R. (1994), "The Value of the Traditional Disciplines", *Cutting Edge,* April/May.

3 Walpole, H. (1926), *Reading,* Jarrolds, London.

4 See *English in the School Curriculum - a Submission on the Draft,* a submission by the Education Forum prepared with the assistance of Professor C K Stead, April 1994.

> The crown of English studies ought to be the encounter with literature, which offers the best, richest and most exciting examples of language use, the folk stories of our inherited European culture as well as the tales of our own settler and post-colonial experience - a fund of wisdom, a storehouse of fact, and a range of experience beyond the powers of any one person to live in many lifetimes. The very best of poetry or fiction exposes readers, as often as they care to open a book, to the influence of minds and sensibilities finer, more developed, richer, than they are likely to meet more than once or twice, if ever, in real life.

Much the same could be said of great art and music. At a time when so much of the media and modern literature are concerned with the banal, the ephemeral and the exploration of evil rather than of virtue, to introduce young people to finer minds and greater sensibilities would seem to me to be a priority for schools. Much of the daily literary fare in modern society deadens or limits the sentiments and creative imagination. C S Lewis[5] observed that from his experience as a teacher, the "task of the modern educator is not to cut down jungles but to irrigate deserts."

The humanities address fundamental questions

My third point is that the humanities help us to address the great issues of life itself: "Why are we here?" and "What does it mean to be human?" The word "humanities" does, of course, share a common origin with "human" and "humane". It has something to do with the business of being human. As our intellectual whakapapa, the humanities not only tell us where we come from intellectually but they also provide us with bearings with which to navigate our lives and benchmarks against which to appraise the present. We all too easily think that the discoveries of yesterday are irrelevant to the problems of today. In some cases that is true. But the fundamental questions about being human remain notwithstanding the microchip, hyperlearning, the information highway and, of course, "seamless" education. Men and women have wrestled with them through the millennia and the humanities can bring the conclusions of the great minds of the past to the issues that are still with us today. Susan Moore[6] points out that a common reaction of students reading Aeschylus or Euripides for the first time is "He's so modern! Did he really write that over 2000 years ago?"

Dame Leonie Kramer[7] has written that the relevance of the great minds of our Western tradition:

> ... is their persistent engagement with fundamental questions. What is the nature of the universe? How has man over the centuries tried to explain its origins, purpose and design? What are our human capabilities, weaknesses, responsibilities and strengths? How do human beings organise themselves? How do they distinguish good from evil, beauty from ugliness, right from wrong? It is not only in philosophy and history that these questions are raised. It's in poetry, fiction and drama and, though wordlessly, in painting and in music.

The humanities introduce the classical origins of much western thought

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5 Lewis, C.S. (1943), *The Abolition of Man*, Oxford University Press.

6 Moore, S. (1990), *The Clean Sea Breeze of the Centuries*, IPA Review, Spring.

7 Kramer, L. (1988), "Schools and the Transmission of Culture", *News Weekly*, July 6.

My fourth point refers to the classical languages of ancient Greece and Rome - the writings in which are central to any definition of the humanities. Without them we cut ourselves off from our intellectual origins. They were the languages of philosophy, literature, poetry, law, military matters and administration. The ideas in both these languages underlie much of modern thought. To learn how to access those ideas in the original languages requires a great deal of hard work but the dividends are considerable. The rewards are intellectual pleasure certainly, but also the mental discipline that illuminates other subjects and intellectual activities.

Latin provides a ready entrée to modern languages such as French, Italian and Spanish which started life as Latin dialects. It is also immensely valuable in learning our own language. Not only has English taken on many Latin words but having to learn Latin helps students understand the structure of English. You cannot get very far in Latin without learning the difference between the active and passive voices or what a participle is. Dr Paul McKechnie of Auckland University has referred[8] to the practical benefits for disadvantaged children. "Research in deprived high schools in America has shown that children who do a little Latin make spectacular gains in English - specially in understanding technical and scientific language." "Latin", he says, "is an effective tool for combating disadvantage". He concludes that Latin is vital to our culture, and that it is what parents want.

The place of the humanities in the New Zealand curriculum

So much for the importance of the humanities. My second question was about the place the humanities seem set to have in terms of the curriculum framework and the relevant curriculum statements. The answer in brief is: "Not very much". There are no references in the Foreword to the framework or in its opening statement (pp 3-5) to what I understand to be the humanities. The word 'culture' is mostly attached to the prefixes bi- or multi- and in context refers to the fact that different cultures are represented in schools rather than to the importance of identifying, teaching and building on the best intellectual and artistic elements of those cultures irrespective of their authors' gender and ethnicity. The emphases are on personal development and present and future needs, including economic, rather than on continuity with the past.

The principles which are to give direction for school curriculum development are based "on the premises that the individual student is at the centre of all teaching and learning ... ". This sets the tone for the document in an unfortunate way for those concerned with the promotion of the humanities. Putting the student at the centre of all teaching and learning means that all else has to revolve around the student. This is the ultimate in individualism because student differences are to be emphasised, not what is common to them as members of the human species or as inheritors of a common culture. As a pedagogic approach it calls for a total differentiation of the learning process in the case of each child - an approach which Brian Simon[9] criticises as "not only undesirable in principle [but also] impossible of achievement in practice." For our present purpose, however, the point is that, within this approach, each and every student stands alone, outside and, if necessary, against traditions, authorities, history, institutions, responsibilities, obligations and cultural inheritance. Indeed the idea of a cultural inheritance is of doubtful validity in a system in which we start afresh, as it were, with each and every child. And there is, of course, also no sense that

8 "Latin Lip Service not a Solution", *The Dominion Sunday Times*, August 9, 1992. For a discussion of the linguistic benefits of Latin, see Rudolph Masciantonio, "Tangible Benefits of the Study of Latin: a Review of Research," in *Foreign Annals,* Vol. 10, 1977.

9 Simon, B. (1981) *Why no Pedagogy in England?*

there are matters of intrinsic worth irrespective of whether or not the student perceives their value at the time.

The individual principles of the curriculum framework reflect this central premise of student-centredness. There is much about 'giving to', 'enabling' and 'empowering' students. Consistent with the central premise, the school curriculum is to "respect ... the ... values of all students". This is an astonishing requirement which only the most selective of schools can meet - those only for fully certificated saints - at level 8 in sanctification! Other schools will, presumably, have to respect the values of students who, for example, bully or are cruel to animals. Alternatively, schools will have to look with a Nelsonian eye on this framework requirement.

Important for any concern about the humanities is the requirement that "All programmes will be gender-inclusive, non-racist, and non-discriminatory, to help ensure that learning opportunities are not restricted". What does this mean for the choice of literature and art? Schools are, presumably, to choose material according to racial and gender criteria rather than intrinsic merit. This is, in fact, confirmed when we come to the description of the "Language and Languages" essential learning area, which requires that "In selecting authors and texts, schools will have regard to gender balance and to the inclusion of a range of cultural perspectives." Certainly there is no question of intrinsic merit as a criterion of selection here - to me a quite deplorable state of affairs.

The 7th and 8th principles both refer to cultural matters, though in the contexts of the Treaty of Waitangi and "the multicultural nature of New Zealand society". We should not, of course, expect that all the principles will deal with the humanities, and the concern here is that the school curriculum should, very properly, acknowledge the various traditions, cultures, histories and languages represented in New Zealand. For those concerned with the humanities, the problem is the cultural relativity that is introduced with the requirement that "the experiences, cultural traditions, histories and languages of all New Zealanders are recognised and valued." The aim, as I read these principles, is sociological rather than the cultural, intellectual and moral development of students through the study of what Matthew Arnold has called "the best that has been known and thought in the world". To the contrary, any discrimination between cultures in terms of their worth to the humanities would seem to be excluded. Cultural relativism is the preferred order of the day.

The introduction to the learning areas (p 8) provides some hope for the humanities because it explicitly refers to "culture and heritage" as being included in a number of essential learning areas. They are, however, quite hard to find. As I have already noted, the references in "Language and Literature" to texts and literature are heavily circumscribed by cautionary words with a clear sociological intent. Little hint of what Matthew Arnold had in mind is to be found. Learning another language is, we are told, culturally enriching and I have found this to be very true. Language learning should not be regarded as merely a benefit to international relations and trade.

A notable omission of concern to those involved with the humanities is any reference to the classical languages of Greece and Rome. I would like to think that this was mere inadvertence. But I fear not. An earlier Ministry of Education report on language policy[10] had little support to offer for Latin and classical Greek. These languages are, I suspect, regarded as elitist, not relevant to international trade and, perhaps, simply too hard and, therefore, likely to damage the fragile self-esteem of all those sensitive children with whom our schools are seemingly so amply populated. School children

10 *Aoteareo - Speaking for Ourselves* by Jeffrey Waite, Learning Media, Ministry of Education, 1992.

elsewhere must be more robust. A media article[11] reports that Latin is still studied by 50 percent of German secondary students and in post-communist Hungary - where it was the official parliamentary language up till the last century - Latin is enjoying a resurgence. At Boston University a Latin and Greek course has been established at a special feeder school to relieve what was reported to be "the massive boredom" students face in the modern curriculum[12]. It is ironic to me that New Zealand, whose own national literary heritage is so recent, has dispensed with Greek entirely at the school level and seems to be in the process of doing the same with Latin, while other countries with a national literary heritage dating back many centuries do not. Paul McKechnie[13] says that parents want Latin; clearly many of them will not get what they want for their children.

My last hope and confident expectation was that the penultimate Learning Area - Arts - would provide a really strong statement about the importance of studying the best of the arts in our Western and Maori cultural heritages. Certainly students' "own heritage and other cultures" are mentioned but again so couched in words of cultural relativity that no sense of intrinsic worth can be admitted. Moreover, such learning is to recognise the achievement of both women and men, so here again we do not find an aesthetic and educational aim emphasising cultural excellence but a sociological one.

In keeping with the basic premise of student-centredness in all learning and teaching, we are told that the "arts are important to the growth of self-knowledge and self-worth." I am uncertain what is intended here. However, I would note that exposure to greatness in whatever form, intellectual and artistic included, may not improve one's sense of self-worth - indeed it can be thoroughly damaging to it. Perhaps all art galleries and museums purporting to show great works of enduring value for civilisation should prohibit entry to school children and be clearly signposted - THESE EXHIBITS MAY BE DAMAGING TO YOUR SELF-ESTEEM. The point is, of course, that the response to greatness is awe and humility - the opposite to a heightened sense of self-worth. Self-knowledge? Yes, but only if that knowledge leads us to a realistic assessment of our own endeavours and provides encouragement to reach our potential.

The only curriculum statement that has been published thus far in which I would expect to find the humanities strongly represented is the draft one for English, and it is sadly lacking in clear reference to them. Further, rather than point to norms of excellence, "learning programmes should affirm the value of the learner's own language and experience" (p 10) which could mean that schools should affirm the illiterate in their illiteracy and the unintelligible in their unintelligibility. Professor Karl Stead has commented[14] on this requirement:

> The pretence that a minimal vocabulary, slovenly articulation, and an ignorance of the written word, deserve to be 'affirmed and valued' because they happen to be what the student arrives with, is patronising and will fool nobody, least of all the one in need of help.

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11 "Latin Trade-off Raises Fears", a report of an interview with Professor Vivienne Gray, *The Dominion Sunday Times*, September 6 1992. See also THES of October 4, 1991.

12 See THES June 12, 1992.

13 Op. cit.

14 Op. cit.

The draft English curriculum statement's guidance as to choice of literature is also disappointing. The criteria emphasise race and gender of author and the range of perspectives represented in the texts - not their intrinsic literary merits. Karl Stead[15] again:

> Thus the most specific and absolute requirement is that consideration should be given to local and 'gender-inclusive' content (New Zealand/female/Maori), and that something (anything - the choice is open) of the wider perspectives which 'literature in English' signifies, should be included.

The problem is, of course, that the humanities are about far more than race and gender, but if we persist with the approach of the new curriculum many students will never know it[16].

Some reflections on the social studies curriculum in relation to the humanities

Finally, I want to reflect on the proposals for the new social studies curriculum in relation to the humanities. My immediate inclination would be to insert into the general area of social science all the aspects of the humanities that are missing from the other learning areas. However, I know this is impractical, and its insertion would abuse the concept of a social science curriculum. The prior task is to revise the curriculum framework itself - in my view some of it is muddy and a muddle as some of my earlier remarks will have indicated. I consider that the framework should set the student in a relational, historical and cultural context; provide some guidance about how much curriculum time should be allocated to the various subjects; affirm the academic component of education as well as the importance of personal development; dispense with the ten levels; seek to set out in language as straightforward as possible what should be covered at each Form level with guidance about the minimum acceptable level of achievement for progression; and stress the importance of high quality, rigorously assessed 'exit' qualifications. The humanities would find their proper place in English, the arts, philosophy, and the classics.

My problem with the social studies component of the social sciences learning area is that I don't have any background knowledge of it. Nor do I have any experience of curriculum development. I can, therefore, do little more than make observations and pose questions. I have to confess that my most basic question is "What are social studies?" A satisfying answer would, for me, first deal with the aims of the subject including the content - the knowledge, understandings, concepts and so on - to be delivered. It would then seek to identify the best means of delivering that curriculum. It would also set the subject in the context of other social science subjects and the rest of the curriculum.

The description of the social science learning area is a formidable mixture of components - world history, New Zealand and other cultures, religions, civics, values clarification, social anthropology, economics, the environment, "global issues", New Zealand's international trade situation, and many more. Schools are, however, to "provide balanced learning" in the social sciences which I understand to mean providing learning in social studies, history, geography and economics. However, it is still not clear from the description of the social science learning area what social

15 Op. cit.

16 See Cheney L.V. (1992), *Telling the Truth - a Report on the State of the Humanities in Higher Education,* for a discussion of this issue in American higher education.

studies are. I am left with the unwelcome conclusion that it consists of whatever in the list of social science components are *not* history, geography or economics - for example, values clarification, "global" and environmental issues, and civics.

I would like to think that there is a better way to define social studies - that it is not simply whatever cannot be incorporated within more established disciplines. A definition by exclusion is unlikely to be intellectually satisfying. To an outsider, however, a social studies programme can seem like an amalgam of bits and pieces that don't obviously belong elsewhere - the curriculum equivalent of the Department of Internal Affairs - with a bit of ancient mythology today and a bit about modern South Africa tomorrow. One problem with such diversity must be the resulting difficulty in providing the balance and coherence which the curriculum framework document says, quite rightly, are very important to education at the school level. So one issue for the curriculum developers will, no doubt, be to establish the criteria by which components are selected in order to provide the required degree of balance and coherence.

Another problem with what seems to be the diversity of the subject is how to provide a sense of continuity and causation. If the word "seamless" has any proper currency in education, it is surely in areas like civics and history in which nothing can be properly understood in isolation. Furthermore, how do teachers present the diverse components which seem to make up, or contribute to, social studies within a single set of intellectual concepts? Without this sense of coherent intellectual discipline, some teachers may tend to present social studies as vehicles for propaganda or pursue the false gods of relevance by turning them into 'current affairs'. In so doing they would deny their charges access to the accumulated intellectual capital which is their inheritance and which forms part of the humanities broadly defined.

I have seen no discussion about, and analysis of, the five proposed strands and four fundamental themes for the Social Studies curriculum statement, so I do not know what led to these decisions. In the absence of this information, as well as my lack of background knowledge, I can only give my immediate reactions for what they are worth.

- The strands as identified could be interpreted to incorporate just about anything and everything and the resulting subject could lack clear identity and content. They could certainly include history, geography and economics, which raises questions about the interface between social studies and these other social science subjects.

- The fundamental themes seem firmly locked in New Zealand's present, and it is unclear to me how they will relate to the strands which do include the past. In any case, it is worth reflecting on John Dewey's belief that the achievements of the past provide the only means at our command for understanding the present.[17]

- The themes are focused exclusively on New Zealand and countries of significance to New Zealand. This seems very limiting. How do we understand ourselves except in the context of our British, European and Polynesian past? And are school students to learn only about those other countries with which New Zealand has significant links? Again, however, it is unclear to me how these themes are to relate to the strands which potentially have a much wider focus.

- It seems to me that students are expected to pursue strands without the prior establishment of a base of history, geography and economics and

17 See especially Dewey's *Experience and Education*.

the methods employed by those disciplines. Should not these come first and the investigation of strands take place much later, in the senior secondary school and university, *after* this foundation has been laid?

- If the social studies curriculum is to be a portmanteau one without a clear identity, including a solid knowledge base and disciplined methods of analysis, it will attract less able students and teachers, and teachers and texts with an ideological bias will proliferate. I have, by the way, recently seen a work sheet for a F4 social studies programme which required the pupils to invent politically correct slogans for women's sufferage (sic) year. Clear identity is, I suspect, critical to acceptance of school-based qualifications in social studies by employers and tertiary institutions.

- Without a conceptual basis, social studies will be not be intellectually satisfying - this will be the case whether they are no more than "dates and bays" or whether they are a vehicle for propaganda. Politicised social studies may evoke indignation over past and present injustices but using education to promote such feelings isn't introducing anyone to a discipline such as history and won't sustain intellectual interest. One senior teacher commented to me recently with reference to social studies: "Students like 'meat' [in their education]. They feel unhappy if there is no 'soul' or 'body' to what they are studying." And it is a proper educational 'soul' and 'body' that, it seems to me, are lacking in the proposed strands and themes for the social studies curriculum statement.

- If social studies include elements of history, geography and economics, the implications for teacher selection and training are enormous. Is it, in fact, realistic to expect that social studies teachers will have a substantial, up-to-date knowledge of all these areas including an understanding of the concepts and analytical techniques inherent in these disciplines?

If these difficulties do, in fact, exist those responsible for drafting the new curriculum have a formidable task ahead of them. I wish them well. However, it does seem to me that unless social studies can be given clear definition as to structure, content and intellectual discipline, the question must be addressed whether or not they should remain as a separate subject within the social sciences area. An alternative approach would be to narrow the focus of social studies. For example, civics could, presumably, be developed as a coherent body of knowledge, concepts and analytical techniques centred around the beliefs and debates that led to the development of modern democratic institutions.

The humanities and the business sector

Before bringing my talk to a close, I want to reflect for a moment on why the humanities are important to business people and the organisation for which I work. I would make just three points. First, New Zealand business people are as concerned as any other group in the country for the cultural and intellectual quality of our national life. Secondly, the New Zealand Business Roundtable has a focus on issues of broad national importance - it is not narrowly focused on issues of immediate concern to the business sector. It has identified education as a top priority area. Its view, in brief, is that what is good for New Zealand is good for business - not the other way round. Thirdly, the idea that business people are simply concerned that schools should turn out 'factory fodder' is very far from the truth, and represents a gross misunderstanding of modern business. Businesses seek a variety of knowledge, skills and competencies in their employees, and they recognise that the humanities have a part to play here. An OECD report[18] put it this way:

> But what is often overlooked is that the humanities, however broadly or narrowly we wish to define them, are uniquely poised to cultivate a range of competencies regarded as essential for everyone in a society of such growing complexity. It is in the humanities that a teacher may find the most varied opportunities to stimulate rigorous thinking, to promote communication and interpersonal skills.

Summary and conclusion

The humanities are essential for intellectual and cultural growth and for a civilised, compassionate society. Schools have a major part to play in introducing them to our young. Current curriculum developments do not appear to give them adequate importance. Good schools and good teachers will carry on regardless but, over time, these curriculum developments can be expected to have a deleterious effect on national life and culture. My policy prescriptions to counter this trend are: rewrite the framework document as already outlined; re-emphasise the classics; insert into the final English statement a strong emphasis on the best and richest of our English literary heritage and do the equivalent with the arts curriculum statement; and, finally, give social studies a strong, coherent content and intellectual base, if necessary by narrowing its focus.

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18 OECD, (1991), *Curriculum Reform and School Effectiveness - a Report on Progress and Steps Taken for Future Action*, CERI/CD(91) 9 September.

SECONDARY PRINCIPALS' ASSOCIATION OF
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CUCUMBERS, STALE BREAD AND EDUCATIONAL FRAMEWORKS

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CUCUMBERS, STALE BREAD AND EDUCATIONAL FRAMEWORKS

I have no doubt that the curriculum and qualification frameworks are much on your minds during this conference, and I would like to allocate my few minutes to those subjects. First, I would like to refer to another set of frameworks from which we might draw some profitable lessons. I refer to the political and economic frameworks of the European Union.

The decisions of the Union's bureaucrats are a never-ending source of amazement and often of amusement. The latest news is that they have banned *curved* cucumbers and declared that the feeding of stale bread to swans is illegal. What concerns bureaucrats have with the shape of cucumbers is unclear. Perhaps European commissioners just want to define everything in sight in a nice tidy way so that their regulations can be less easily evaded. Even the humble cucumber is not allowed to escape their net.

I don't know the cost to those market gardeners who grow crooked cucumbers. Perhaps they are jailed, fined, or forced to put their cucumbers into straitjackets.

The problem with stale bread is, apparently, that it is waste and must, therefore, be controlled. Hence if you want to move stale bread from a bakery to a river bank where it can be fed to swans, you have to have a permit. And every time the stale bread changes hands down the 'waste disposal chain', a transfer note must be completed to show that it has been handed on to an 'authorised person'. You can imagine the bureaucratic triumph this represents. The bakery owner, the bakery assistants and the men, women, girls and boys who collect the stale bread and take it to the swans all need to apply, no doubt in triplicate, to a person authorised by the European Commission to authorise.

The cost of the stale bread control mechanism is likely to be fewer of those beautiful creatures since many of them apparently only survive through the activities of voluntary wildlife societies and the willingness of bakeries to let them have their stale bread for swan food. And a little more of local community life has been put to an end by a rampaging bureaucracy. It is not just that the volunteers and bakery staff will be deterred by the red tape, though that will undoubtedly be the case. To be an authorised 'waste disposal person' requires the payment of $6000 for the necessary licence. Not many voluntary organisations can afford that.

All this may seem a bit remote from the issue of educational frameworks. We are, thank goodness, a long way from Brussels and not within the European Union and its ominous army of officials. And yet there are lessons here for us. We need to be careful that the education system does not become victims of the same regulatory madness. How does the process get started? The original aim of the European Union was to ensure, through trade links and common political institutions, that the European powers would never again go to war dragging the rest of the world with them. Somewhere along the way, Europeans moved from the pursuit of this eminently laudable aim to such absurdities as regulations to define the shape of cucumbers and the disposal of stale bread. How did this happen?

I suspect it is the case that good ideas were pushed way beyond their limits by dedicated enthusiasts who never stopped to think about what those limits should be - or, perhaps, just never stopped to think. In such a process the original aim becomes lost and other less laudable aims take its place. A momentum builds up. Waste is potentially harmful. Its disposal must therefore be controlled. Hence waste disposal experts, authorisation criteria, people authorised to authorise, waste disposal licences and fees and, ultimately, fewer swans.

The owner of a bakery is reported to have said: "I'm not paying for a licence to give away bread. And if I had to fill in one of their forms, I would be using a few expletives. My wife's got the right idea about Europe. She says we should start by blowing up the Channel Tunnel and then move on to Brussels." It is ironic that the process that started with the intent of avoiding war is breeding such bellicose sentiments.

I have reflected on the curriculum and qualifications frameworks over the last couple of years and have recently completed a report on them. It should be publicly available shortly. One of my conclusions is that education is not immune from the process which I have just described. In my view, some good ideas in education have been appropriated by enthusiasts with the best of motives, and pushed well beyond their proper educational limits because those limits have not been adequately thought through. The outcome is often perverse. I want to give you some examples of this from the curriculum and qualifications frameworks.

The first 'good idea' is that education and training should be concerned with outcomes rather than with the educational process. We see this concern given considerable prominence in the new emphasis on defining subject curricula and the unit standards in terms of outcomes. Coupled with this is our preoccupation with measuring performance against pre-set standards, performance criteria and range statements. And what could possibly be wrong with that? Surely education and training are to effect positive changes in knowledge, skills and attitudes? Should we not be clear about what those desirable changes should be, and be able to ascertain whether or not they have taken place?

Personally I think there is much to be said for a focus on outcomes - as long as we heed the dangers of pressing it too far. The first danger is that we end up concentrating on easily definable outcomes and lose sight of those which are less definable. We want to concentrate on straight cucumbers but not curved ones. The problem is that many of the more important educational outcomes are of the curved variety and don't easily fit into neat and tidy categories. More importantly, the assumption that the outcomes of learning can always be specified in advance is a nonsense - it is to fundamentally misunderstand the nature of education.

A second danger with this outcome focus arises from the assumption that if students can demonstrate ability to achieve a certain result they must necessarily also be demonstrating the understanding and knowledge that are normally associated with that achievement. Unfortunately this assumption is highly dubious. In Britain it has led to a decline in emphasis on mathematics and other core skills as requiring separate instruction and assessment. We could be heading in the same direction in New Zealand. The NZQA will respond that knowledge can be accepted as an outcome. But it is also clear that the NZQA prefers application and interpretation of knowledge in a specific context rather than its demonstration for its own sake.

We have yet to see any unit standards in academic subjects, and I do not know how the NZQA is going to turn academic knowledge into clear outcome statements. In any case the division of general educational subjects into numerous small bits is likely to render them unrecognisable as general education, and will reduce opportunities for seeing how well students can integrate learning from different areas.

The third danger of the outcome approach is the critical one of standards-based assessment. Certainly we should do all we can to clarify in advance what students are expected to learn, what teachers are expected to teach, and the basis on which assessments will be made. But, as Professor Warwick Elley has pointed out on frequent occasions, this form of assessment is simply not appropriate in cases where standards cannot be easily defined. In fact, only in a relatively small number of tasks is standards-based assessment suitable. In particular, it would seem to have little potential in general academic-type subjects. It is noticeable that the outcomes in the curriculum statements so far produced are, in fact, far from clear.

The second 'good idea' that is being pushed too far and which may be rapidly becoming a thoroughly bad idea is that education should be 'student-centred'. In a sense education is, and should be, student-centred. By this I mean that students should be treated as individuals, that teaching should take account of students' existing knowledge and understandings, and that their individual progress in cognitive and affective terms should be of concern to teachers.

But the principles in the curriculum framework "are based on the premise(s) that the individual student is at the centre of all teaching and learning ... ." This, in my view, is well-intentioned but romantic nonsense. It has led to the omission of certain values traditionally thought to be central to education, for example the view that knowledge is of value irrespective of the views of the student, and that education has something to do with the acquisition of wisdom and the ability to discriminate. Is it not also the case that we all live in a complex society of relationships, rights, duties and obligations, with an extensive culture and a long history? It is hard to see how we can prepare young people to take their proper places in such a society if the central premise of their education is that each and everyone of them is at the centre of all teaching and learning.

Let me expand on my reference to the ability to discriminate which I used in a positive sense - a sense which is lacking in the curriculum framework except for one minor reference in relation to the media. The negative sense is certainly there. School programmes are to be gender-inclusive, non-racist, and non-discriminatory (p 7). This negative sense is likely to lead to problems in, for example, the selection of English texts. Following the framework's principles, the draft curriculum for English requires that in selecting authors and texts, schools will have regard to gender balance and to the inclusion of a range of cultural perspectives. What these and other requirements lack is any reference to literary merit as a criterion for selection. A romanticised student-centredness may meet some short-term emotional needs of some students but at the expense of their literary development and their exposure to great literature.

In my view, education has, *as a primary role*, the inculcation of the ability to discriminate - in a positive sense. Education should encourage discrimination - not, of course in terms of race and gender, but between the good and the bad, the substantial and the trivial, the noble and the ugly, truth and propaganda, and so on. This can be unsettling because it challenges and takes little for granted. It is an ability that, certainly in older students, should challenge the teacher and college lecturer. It leads to an independence of mind that may, just conceivably, conclude that the latest politically correct pronouncement by some educational authority is a load of humbug. In terms of knowledge, the development of our critical faculties requires acceptance that there is a real world independent of the student which is capable of being investigated and before which the student is supplicant and not ruler. Living in a relational and cultural context means that individual values often have to be informed, disciplined and shaped. But this is not the likely outcome of an education centred on the individual which may only clarify and confirm wants, desires and prejudices.

On the question of values, have you noticed that the sixth principle of the framework requires the school curriculum to recognise and respect the values of all students? I wonder how many of your schools do that. Should we respect the values of someone who believes that bullying or cruelty to animals is acceptable behaviour? This seems to me to be an absurdity in the 'stale bread' category. In a sense you are *in loco parentis* for your students. But when it comes to the family values that many of your charges bring to your schools, it is unfortunately the case that all too often you have to act *contra parentem.*

The curriculum framework says nothing about pedagogy though much is implied. If the student is really, as the framework would have us believe, the centre of all teaching and learning, you and your teaching staff are merely facilitators. You have no authority, you have no body of knowledge to transmit to each new generation, ultimately there is nothing to teach. You are there simply to help students discover what they will, when they will, how they will. Above all, you must eschew all dogma. The problem is, as G K Chesterton pointed out, "(d)ogma is actually the only thing that cannot be separated from education. It *is* education. A teacher who is not dogmatic is simply a teacher who is not teaching." So, taken to its logical conclusion, student-centredness is the end of education - just as regulatory madness may well eventually bring about the end of the European Union as presently organised.

The third 'good idea' is that one curriculum framework can encompass all school-based learning and that one qualifications framework can encompass all qualifications. But surely this is an excellent arrangement? For both frameworks unity of structure means clear lines for progression and hence provides the student with encouragement to progress. For the qualifications system it means fewer artificial distinctions based on status between academic and vocational awards. The use of a common building block - the unit standard - enables a wide and flexible range of qualifications to be developed. Basing the unit standards on performance means that prior experience can be recognised and frees the achievement of qualifications from time service requirements.

But irritating questions arise even with such seemingly good intentions - with which, it will be recalled, the road to hell is paved. For example, as regards the curriculum framework, will one curriculum statement in each subject provide for all ability ranges? One professor of education has asked, in relation to the new mathematics curriculum in England and Wales, whether it is sensible to offer the same syllabus at secondary-school level to pupils of vastly different abilities, interests and employment intentions, simply allowing more able students to 'snip off' more of a subject than less able pupils, as if a school subject were a 'piece of tape'.

Also in relation to the curriculum, is it sensible to provide for one structure for all curriculum statements? We have a structure of strands, levels and objectives determined independently of the subject curricula. It is not clear to me that this is a good procedure. Indeed it smacks too much of putting the cart before the horse. Already we see some strange manifestations of this. In the draft English curriculum, for example, we find a "visual" strand of language which is to be given equal status with the other two strands - oral and written. And an "expressive" function of language is identified as if other forms of language are, somehow, not "expressive". The maths curriculum provides six strands which it states are "all equally important" (p 16). Thus we find a statistics strand which starts at Level 1 when surely priority should be given to more basic matters such as number. All this seems to me to be the outcome of an attempt to make subject curricula conform with the framework rather than to allow the subject content to speak for itself. The result is, in my view, artificial and educationally damaging.

There are similar sorts of questions about the qualifications framework. It depends for its flexibility on a common building block - the unit standard. But can all knowledge, skills and understandings be reduced to this format without reductionism and rigidity? Can all outcomes be divorced from curricula? What will happen to the coherence of the subject matter? Will the traditional subject disciplines be eroded? Is it really possible to allocate all knowledge, skills and learning from prevocational training to postgraduate work in a consistent manner to one of only eight levels arranged hierarchically? And what will be on offer in the senior secondary school?

Can the qualifications framework provide alternative pathways meeting the educational needs, interests and employment intentions of all senior students while also incorporating the good foundation of general education which is essential for job mobility and full participation in an advanced democratic society? And will those pathways lead to high quality, rigorously assessed 'exit' certification? I have to say that I have serious reservations on most of these questions, and propose different approaches in my report.

Time does not allow me to develop these issues further. Let me just conclude by saying that, in my view, we are in real danger of pushing good ideas far too far and ending up with educational absurdities. It is never too late to stop and think through the issues. The British government has had the good sense to drop some earlier education proposals where it had over-reached itself, despite the temporary political embarrassment involved. But the longer we leave it the more momentum is built up, and the more difficult it is to change direction which, in my view, is what we now need to do. Present developments pose a number of real dangers. The life chances of too many young people are at stake for us to ignore them.

COMMERCIAL LAW AND REGULATION

DAIRY INDUSTRY ASSOCIATION OF NEW ZEALAND
TARANAKI BRANCH

REFORM IN THE DAIRY INDUSTRY: THE PERESTROIKA PHASE

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HAWERA
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REFORM IN THE DAIRY INDUSTRY : THE PERESTROIKA PHASE

I seem to have been involved in the dairy industry in one way or another most of my life. I grew up on a dairy farm. I spent four years in the New Zealand mission in Brussels from 1970 during the British negotiations to join the EEC. I was involved with the GATT minimum price agreements. In the mid-1980s I had a part in the restructuring of the producer boards' debt, including the $600 million government guarantee to the Dairy Board. In my Business Roundtable capacity I have been responsible for our programme of research on agricultural marketing regulation.

Dairying has always been New Zealand's most political industry. When I first helped milk cows on the farm, the predecessor to the Dairy Board was still a government department. Through the 1960s the bulk of our dairy export trade took place under contracts negotiated annually with the Foreign and Commonwealth Office. In Brussels, Laurie Friis, Arthur Ward and Charles Patrick used to arrive hand in hand with Jack Marshall and Brian Talboys. Until very recently the Dairy Board had a monopoly not just over export sales but over the local market and imports as well.

Twenty-five years ago we all thought Brussels was the centre of the world for New Zealand and the dairy industry, and that politics in the form of other countries' agricultural policies determined our fortunes. Slowly it dawned on me that that view was a myth. The New Zealand economy was already doing poorly well before the EEC problems came along.

We were losing market share relative to our competitors. Other countries facing equally difficult problems of market access were doing better. The issue was not so much unfair treatment by the rest of the world but the mismanagement of our own affairs, particularly the Fortress New Zealand policies of the day. As J B Condliffe, Sir Robert Muldoon's favourite economist, put it in 1969:

> A visitor cannot fail to be impressed with this widespread apparatus of regulatory and control authorities. Even more impressive is its acceptance by the community. Regulation has become a habit. ... The future lies within New Zealand's grasp, but to grasp it requires bolder and more imaginative aims than have inspired recent policy. Above all it requires liberation and encouragement of the inventive and creative innovators among its people.

Unfortunately, Sir Robert must have misread Condliffe's book.

The same point can be made in an up-to-date context. The government has forecast that New Zealand's GDP will increase as a result of the Uruguay Round by 2-3 percent over the next decade, compared with what would have been the case without a GATT agreement. This implies an average incremental gain of $150-230 million to New Zealand's GDP over each of the next 10 years.

These gains are well worth having, but a total gain of 2-3 percent is tiny compared with the 35-50 percent increase in GDP over a decade which we can hope for if the economy grows by 3-4 percent a year as a result of the recent structural reforms. In our preoccupation with foreign trade restrictions, we must not allow the tail to wag the dog. It is likely that the greatest gains are still to be made by improvements to our own domestic policies, including those affecting agriculture.

Over the years the dairy industry and the Board have had some considerable achievements to their credit. They have had some very good industry leaders and managers, they have diversified their products and markets and they have built a worldwide network of processing and marketing outlets. In other areas the industry has been slow to innovate: for example it has seen less change in employment relations than practically any other major industry, with national awards still being the dominant arrangement. However, to even the most casual observer, there are a number of curious features about the industry which ought to worry participants in it more than they do.

One is that the marketing arm of the industry is obliged to accept and sell everything that is supplied by the production arm. Can you think of any other business that operates in this way? Imagine what would happen if a wine-making firm kept on accepting whatever quantity of grapes growers sent it regardless of market outlets. To put it only a little unkindly, the Board operates essentially as a disposal agency, getting the best it can from its sales, deducting its costs and paying the farmer what is left over. Whether this is maximising industry profitability no one knows.

Secondly, in order to be a producer in the industry, a farmer is also obliged to invest in processing and marketing operations. These investments are now very large - probably between $300,000 and $500,000 for the average farmer according to recent estimates. However, the farmer has no idea what rate of return is being achieved on those investments. If farmers imputed a normal return to them, many would be surprised to discover how little they earn from milking cows.

Thirdly, the Dairy Board is effectively confined to one line of business - selling New Zealand dairy products. "Sticking to your knitting" is quite a good commercial maxim. The only problem is that the knitting changes - the rail industry had to adapt and become part of the transportation industry in the classic example. Who knows if the Dairy Board could do a better job for its investors if it were able to operate as a food industry multinational like Nestlés? Naturally it can't with its present structure as it would soon face capital constraints and to do so would only make the distortions in the payments system worse.

Finally, at this level of outwardly curious features, export marketing is subject to a statutory monopoly. Farmers and processors are not allowed to sell their own products to foreigners - an extraordinary commercial restriction if you think about it. The only exception to this rule is if the monopolist approves the sale. It is common wisdom, especially among farmers, that monopolies are bad. They have been rooted out of practically every corner of the New Zealand economy yet farmers continue to uphold them in agriculture.

Because of these apparent anomalies in the dairy industry, and similar ones in the other primary industries subject to producer board regulation, the Business Roundtable decided to take a closer interest in the subject. The boards directly control or influence nearly half our total exports, and thus have a major impact on the performance of the whole economy. As an organisation whose prime focus is the overall performance of the economy, we wanted to examine the policy issues from that perspective. Our work to date has taken the form of the ACIL report of 1992 and this year's Ireland, Wallace and Associates report on off-farm assets, together with a number of smaller papers. This research programme is ongoing.

As has always been the case when we have challenged conventional wisdom, a number of interests have felt threatened and have responded accordingly. Our motives have been questioned in colourful language: the whole exercise is a "Trojan horse" for a corporate takeover of the industry; we are out to "rape and pillage" farmers, and so forth.

I can tell you that I have not heard of anyone in the business community who wants to make alcoholic milk shakes or use casein to bond medium density fibreboard. To my knowledge there are a couple of Business Roundtable-related companies - Tasman Agriculture and Apple Fields - with interests in the industry. Neither they nor any others have ever discussed their commercial interests in dairying with me. The day the organisation seeks to advance the specific commercial interests of any of its members is the day I look for another job. Our interests are in the bigger picture: a better economy that is good for the whole community.

It is encouraging that some in the industry are seeing through the paranoia. By far the most heavyweight contribution from the sector itself has been the discussion paper on the structure of the dairy industry recently put out by the Dairy Section of Federated Farmers. On this issue it said, perhaps a little flatteringly:

> ... we must not forget that the Business Roundtable has promoted most of the valuable economic reforms that New Zealand has undertaken over the last decade; often seemingly at the cost of those businesses that most New Zealanders think the NZBR represents.

Although the paper did not fully endorse the analysis we have put forward, it rightly called for a debate on the merits of the arguments.

Besides the kneejerk reactions about motives, the other thing that has struck me about much of the commentary by industry leaders is its shallowness. We have sometimes posed the question: "If the board is such a top notch marketer, why should it be afraid of being opened up to competition?" One response was: "The difficulty is that if we give into this criticism we give away the single seller concept forever." What sort of argument is that?

Sir Dryden Spring is fond of saying that critics of the industry are frustrated because their theoretical arguments are confounded by its success in practice. I am reminded of Sir Robert Muldoon's resistance to reducing protection to manufacturing industry: "I have no intention of letting efficient industries go to the wall for the sake of a theory," he used to say. Do you people really fall for this sort of stuff?

A further irrelevant argument is the unfavourable comparison made between dairying and the meat industry. The meat industry is by no means the unmitigated disaster that many people think it is. The beef sector, which accounts for roughly half total meat exports, has expanded with increasing farm gate returns, whereas returns to dairy farmers have been broadly static in real terms. Moreover, among all our major primary industries, beef has enjoyed the greatest commercial freedom. Particularly in the case of sheepmeat, the meat industry is far from operating in an unregulated, competitive environment. It has been plagued for years by government intervention and Meat Board meddling. Although recent moves have been in the right direction, the Meat Board still has major commercial interests but weak accountabilities, the reserve powers still exist, and there are problems with the allocation of export quotas and the Meat Planning Council guidelines. These institutional weaknesses have not helped the necessary adjustment of the industry. However, the government and the Meat Board are rightly looking to moves such as the removal of the reserve powers and a withdrawal from commercial investments, not greater intervention.

The cooperative structures in the meat industry are a further problem. As in the dairy industry, they give rise to bundling problems and distortions in the price signals to farmers. The idea that cooperatives are somehow better than normal public companies because they don't collapse is profoundly mistaken. At least the fact that most companies in the meat industry have a genuine bottom line means that good money is not indefinitely thrown after bad. Cooperatives are not supplanting the public corporation as the organisational form best suited to most large-scale commercial activities; indeed the trend is in the opposite direction.

Another argument that is out of focus relates to the commercial performance of the Dairy Board. The thrust of our concerns does not go to the Board's performance as a marketer. Many, including of course the Board, maintain that its commercial performance is top rate. Personally I am sceptical: I have yet to discover a monopoly organisation that has performed well over the long term, although the inefficiencies are never fully revealed until the monopoly is opened up to competition. Faced with just the threat of competition, the Kiwifruit Marketing Board claims it has cut its total annual onshore and offshore costs by around $100 million. That is around half to two thirds of the estimated total annual gains to New Zealand from the Uruguay Round, in an industry far smaller than dairy. Reading between the lines, the Boston Consulting Group report seemed to be saying that the Dairy Board did a reasonable job of marketing bulk commodities but was weak at the consumer end, which is what you would expect.

However, the bottom line on the issue of the Board's performance is that we simply do not know: because there is no competitive yardstick, and no equivalent to a share price or other commercial return measure, there is no useful information available. This is one of the key criticisms of the present structure, and it is only addressed in a weak manner by performance audits.

Suppose, however, that the Board and the cooperatives have been making a competitive commercial return on their assets. In this situation the problems really start. The crux of our argument is the extent of the resource misallocations in the industry arising from its structural distortions. An intuitive way of seeing the problem is to compare the situation of dairying with a highly protected manufacturing industry. A protected manufacturer may, like - hypothetically - the Dairy Board, be doing a good job commercially, but the price distortions due to the protected environment encourage decisions which result in a very poor use of resources from a national point of view. The community ends up being poorer than if the resources had been put to better use.

One of the major contributions of ACIL's research was to highlight the so-called bundling problem - the distortions which arise because the returns on off-farm investments are bundled together with the return for milk in a single payout price to farmers. We knew we were on the right track when a very senior member of the industry told us immediately after the report was released: "You're absolutely right about bundling, and the industry isn't moving fast enough to deal with it."

Despite this clear identification of the problem, very little has been done to address it. The Dairy Board has appeared to be paralysed in its response to ACIL's findings. For a while, it maintained that the problem is trivial and that if it ever grew to be important, something would be done. We were convinced the problem is not small, and commissioned the Ireland Wallace and Associates study to get a better feel for its size. This research demonstrated that the problem is indeed a major one. Using an average international industry performance benchmark, the study found that the associated investment return or dividend distributed as milkfat payout in 1992 represented 25 percent of the total, or $1.50 in a total payout of $5.93 per kg. Taking a best practice benchmark, the dividend component rises to 34 percent or $2.04 per kg of milkfat.

These are large figures and their implications are striking. Either the New Zealand dairy processing and marketing industry is performing on a par with its international competitors, in which case the distortions to production at the farm level and to land prices could be very serious. Or it is not, in which case production decisions may not be significantly biased but farmers are getting a poor return on their very large off-farm investments.

Lately the Board has been taking a different tack, and appears to have been trying hard to confuse the issue.

On the one hand, it has been arguing that "all companies bundle," meaning that their dividends combine returns on a range of activities. That is true, but that form of bundling only influences investment decisions not production decisions. A wood grower who is both a supplier to Fletcher Challenge and an investor in the company will be encouraged to produce more wood if the price of wood goes up, not if the dividend rises. The production and the investment decisions are quite separate, which they are not in dairying. This is where the distortions arise.

On the other hand, the Dairy Board has been saying that if necessary the problem can be fixed simply by splitting the milk cheque in two and paying the milk and the dividend components separately. This is also wrong. So long as the investment return is linked to the amount of milk supplied by a farmer, the bundling problem remains. Other things being equal, farmers are being encouraged to produce too much milk because part of what appears to be a price paid for milk is in fact a return on their off-farm investment.

There is no need for the dairy industry to be vertically integrated just because milk is a perishable product. Electricity is even more 'perishable' - it can't be stored at all. Yet as a matter of policy the government has been breaking up the electricity industry into generation, transmission and distribution components in the pursuit of greater transparency and efficiency. There is no reason why vertical integration in the dairy industry should be imposed by law. The structures should allow participants in the industry to see clearly what returns are being achieved at the production, processing and marketing stages of the chain, and to adjust their investments accordingly.

I suspect that in the period ahead we will see the Dairy Board tying itself up in knots trying to find a solution to the structural problems of the industry other than the straightforward one of corporatising the Board and issuing shares to companies or farmers. I am doubtful whether any other satisfactory solution exists, but it is not hard to see why the Board is resisting this conclusion.

For a start, corporatisation would make its performance much more transparent to its owners and the public, and it may be that its returns are not all they are cracked up to be. Most businesses will resist such accountability if they can get away with it.

Secondly, it has been argued that if the Board were corporatised in a conventional way, it would no longer be possible as a matter of public policy for it to remain a monopoly. This is an illogical argument. Fruit Distributors was a company which was given an import monopoly for many years. If there are sound public policy grounds for the Dairy Board's monopoly status, they apply regardless of its organisational form.

The reality is, however, that there are no grounds for wall-to-wall controls over dairy products exporting. Farmers typically agree that monopolies are bad if you have to buy from them but they think they are fine if you're on the other side of the deal. There are two fallacies in this argument.

The first is that dairy farmers are indeed buying from a monopolist - they are buying the marketing services of the Dairy Board and (leaving aside the handful of other export licences) they have no other choice. The fact that farmers own the monopolist makes little difference. They are in the same position as workers used to be under monopoly unionism: if you wanted to be a carpenter or a clerical worker, you effectively had to deal with a monopoly union. You could not look around for a better deal and the monopolist had few incentives to respond to your needs.

The second fallacy is that, much as farmers might like to believe otherwise, a New Zealand single seller has no ability to act like a monopolist in international markets. These are fiercely competitive, as the Dairy Board keeps telling us. New Zealand products compete against products from domestic suppliers and from third countries, and with substitutes for dairy products. The Board tends to agree that if we were only in the business of selling differentiated and branded consumer products, there would be no need for the statutory monopoly. A logical response would be to deregulate the consumer products area forthwith. But even (or rather especially) in the commodity lines, New Zealand has no market power. Whenever did you last hear of producers of commodities like gold or copper trying to set up a producer board in the belief that they could somehow exercise market power?

While it is hard to identify benefits from restricting entry into marketing (except in rare situations such as the UK butter quota where quota rent would be dissipated under competition), there are, of course, significant downside effects. All the normal advantages of competition are sacrificed. Competition is what keeps firms up to the mark. It provides a proper assessment of commercial performance. Very importantly, it stimulates innovation of all kinds. It allows for diversity - no one firm can ever be the best at everything. Competing distributors and retail chains do not wish to have to deal with the same supplier - they want to be able to differentiate their products. There would have to be enormous benefits from single desk selling to justify sacrificing the advantages of competition.

I have yet to hear a cogent argument as to why the entry of Heinz into New Zealand food processing and marketing has been good for New Zealand but similar entry into downstream dairy businesses would not be. Or why Heinz has been good for expanding ice-cream exports to Asia but would not be good for other dairy exports. Tapping into new marketing channels and stimulating enterpreneurship in the marketing chain would offset or outweigh any contraction in the industry that might result from unwinding the cross-subsidies from bundling. As the Hon John Luxton put it recently:

> Internationally, the food industry is growing and changing rapidly. Last year, Japan invested NZ$1000 million into the Australian food industry, 70 percent of its offshore investment in the food sector. Much of that was into joint ventures involving the Australian dairy industry.
>
> Some might suggest that is a reason to prevent change in New Zealand. But Japanese investment in New Zealand forestry and beef has been reaping substantial benefits for New Zealand producers.
>
> Other countries are investing at a greater rate in adding value in the food industry than New Zealand. We need to improve faster. We need new investment to improve our market position. We need new structures to enable that.

Time does not permit me to go into other aspects of what has become a very wide-ranging debate. One point that has struck me is the enormous amount of time industry leaders and Board executives devote to shoring up their position with politicians and their farming constituents. Someone ought to undertake some research into this activity, which must be to the detriment of running their businesses. No one should think for a moment that this would come to an end if the Business Roundtable folded its tent. The genie is now well and truly out of the bottle. All the government's official advisers, including the Ministry of Agriculture and Fisheries, are on record as favouring change. Coalition governments under MMP are likely to include parties that are not wedded to the status quo. More and more independent observers are identifying agricultural marketing arrangements as a gap in the reform programme of the last ten years. One of the most recent was Professor Peter Lloyd of Melbourne University in a paper to last month's conference of the New Zealand Association of Economists. Lloyd said:

> These statutory marketing boards are part of the long New Zealand tradition of regulating trade, price and production in major agricultural products but they have remained after almost all of the other controls and regulations have been removed. They are one of the few sacred cows in the New Zealand policy pantheon. ... There is nothing different about trading butter or cheese or apples to trading timber products or shirts or banking services. The New Zealand attitude that there is something special about agricultural commodities is the very attitude the New Zealand and Australian governments have been attacking vigorously for many years in the GATT ... . There is a need for study of the political economy of the primary industries. One can readily understand why Board members and employees will oppose the abolition of Boards or Board powers but why do a majority of the producers apparently favour their continuation?

It is good to see Federated Farmers and others in the industry now joining in the debate. There is much more work to be done to tease out the ramifications of the analysis and the reform options; we have never seen our work as a comprehensive blueprint. For our part, we are undertaking further research aimed at drawing out and where possible quantifying the resource misallocation effects of the present structures. We will also be making the point that this is a national issue which governments must address from the perspective of the interests of the overall community. It is no more legitimate for participants in the industry to be allowed to write their own protective rules than it is for manufacturers, trade unions or the coastal shipping industry to be allowed to write theirs. The minister of agriculture's stance that "we will do whatever the industry wants" carries with it the unspoken rider: "regardless of the cost to the rest of the community". This stance should have gone out with Muldoonism.

My reading at the moment is that participants in the industry have reached varying positions in the debate. Some are still stuck in the Brezhnev era, not realising that the world is changing around them. Last year it looked as though they might offer a small concession by changing the name of the Board - *Rural News* suggested Cow Corp - but they seem to have backed off that idea as being too radical. Now they are trying to contain the debate behind closed doors, resisting *glasnost* or openness.

Others, probably the majority, have reached the *perestroika* phase. They recognise that something has to change, but are trying to find a means of restructuring within the old system. However, like Gorbachev, I suspect they are skiing in front of an avalanche. The tensions within the system will just keep growing.

Finally, there are the dissidents and reformers. They are to be found in scattered numbers in farming circles, in the companies and in the lower echelons of the Board. They have not yet penetrated the upper reaches of the Party. My guess, however, is that it is only a matter of time. Who will emerge, in the industry or politics, to pull down the Berlin Wall?

INSTITUTE OF DIRECTORS
AUCKLAND BRANCH

BETTER BUSINESS LAW: THE ROLE OF THE INSTITUTE OF DIRECTORS

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AUCKLAND
13 JULY 1994

BETTER BUSINESS LAW: THE ROLE OF THE INSTITUTE OF DIRECTORS

I want to start by reading you an interesting letter which appeared in *The Economist* last year.

> It is the role of "mavericks," the letter began, to extend the boundaries of debate and ensure that the unthinkable becomes not only thinkable but policy. The Institute of Directors is proud of its record of promoting causes so far ahead of their time that they have been deemed incapable of inclusion in any political agenda, only to see them become received wisdom, and find their way on to the statute book.

The letter went on to ask:

> Could telephones, gas, electricity and even water be privatised? Could trade unions be brought within the law? Could the top rate of income tax be reduced from 98% to 40%? Could inheritance tax on business assets be abolished? Could wages councils be abolished? Fat chance.
>
> And the sceptics are still at it. Can the Bank of England be independent? Can the hard ecu be the common currency for Europe? Can public spending be cut? Fat chance.

And the letter concluded by saying:

> When the day comes, sooner rather than later, that public spending is cut, and its growth is contained at less than the rate of GDP growth, then some taxes, whether on spending or income, can be abolished in time. Income taxes? Every chance!

The writer was Peter Morgan, Director-General of the Institute of Directors in the United Kingdom. As the letter indicates, the IOD in Britain has played a prominent role in promoting the economic reforms in that country in the last fifteen years. Among business organisations it has been foremost in arguing for changes that seemed radical at the time, and its thinking and approach have been similar to those of the New Zealand Business Roundtable in this country. It has published a good deal of research, including a recent paper on New Zealand's economic turnaround.

Tomorrow is the tenth anniversary of the 1984 election which marked the beginning of New Zealand's economic reforms and the improvement in our fortunes that is now apparent. The Economic Summit of that year, of which I chaired the Steering Committee, reviewed New Zealand's 30-year record of poor growth, rising unemployment, a decline in social services and increasing social discontent. We need to remember the diagnosis made at that time when people attribute such ills to the changes of the last ten years.

The Summit said that "Continuation of this trend would be intolerable and policy should aim to reverse it permanently." It reached a consensus that New Zealand had to adopt a coherent, medium-term economic strategy to enable it to become outward-looking and compete in the international market place. Although that consensus has been severely tested on many occasions in the last ten years, I believe it now commands widespread support in the business community and polls show most New Zealanders think the country is on the right track.

It has to be said that the Institute of Directors has not played a significant role in the reform programme and I think that is a pity. I believe that the directors of our major public and private companies have just as much a responsibility to interest themselves in national affairs and make a constructive contribution as the chief executives represented on the Business Roundtable.

By comparison with its British counterpart, the focus of the IOD has been very narrow. I have seen little coming out of it on tax, labour law, privatisation and the other topics that Peter Morgan mentioned. Secondly, and again unlike the IOD in Britain, it has not gone in for serious research as a basis for its policy views. And thirdly, in the relatively narrow fields in which it has operated, I believe it has too often backed the wrong horse.

Although I was a founding member of the IOD, I resigned without fanfare a few years ago as a silent protest against the pattern of poorly thought out and self-serving demands which the Institute was pressing on government ministers. The last straw for me was a proposal that membership of the Institute should be made compulsory for directors. At a time when the business sector was calling for deregulation of the labour market and an end to closed shops, the IOD was urging the creation of a new one!

The context of this initiative was the aftermath of the 1987 sharemarket crash, an event which called for calm analysis not knee-jerk reactions. Without such analysis, and, as far as I can recall, without even consulting its members, the Institute's name was attached to a series of rather ill-considered ideas which added to the panic of the politicians. Remember the claims at the time: New Zealand was a wild west market, overseas investors had no confidence in our business laws, no new equity would be raised unless we changed them, and so forth. All were hyperbole, as subsequent events showed.

Roderick Deane, chief executive of Telecom, reflected on the chequered history of the corporate law reform process at a conference of lawyers and accountants earlier this year, and I have brought copies of his address with me. There is little in it with which I would disagree and much that could be added. The thrust of his argument was that while there are some good aspects to the reforms, we have also introduced a great deal of legal complexity and uncertainty. He suggested that instead of concentrating on their prime job of increasing shareholder wealth, directors may have to spend inordinate amounts of time trying to work out whether or not they are in conformance with the law. If so, we may have ended up going backwards rather than forwards.

Others have disputed this assessment. There is a provisional market place test of the competing views, namely the choices the business community is currently making. I understand that the company registration figures for June showed an enormous bulge, and that registrations under the new Act this month show a corresponding scarcity of people who were anxiously awaiting their chance to take advantage of the new law's benefits. On the theory that the ultimate test of good and bad countries, and the ultimate test of an allegedly helpful law, might be similar, namely whether people are clamouring to get in or to get out, it is strange indeed that there was not a pent-up flood of registrations on 1 July. Instead there was a rush to secure for the three remaining years the supposed disadvantages of the existing law.

One issue on which there is a clear consensus is that the law on directors' duties has been changed very substantially. It is expected to increase directors' liabilities for misjudgment, which is likely to be regarded by the Courts, with the benefit of hindsight, as carelessness. Liability may result even for business decisions to take significant risks which are proper because of the prospects of correspondingly larger gains. This outcome is consistent with the advice the Business Roundtable received from a top Australian academic and a leading New Zealand company lawyer when it evaluated the Law Commission's original proposals.

Astonishingly, the IOD urged haste with the law, although it expressed some reservations in the submissions it made to the select committee. In public statements it castigated those it considered responsible for the delays, in contrast to the warnings of bodies such as the Law Society about unresolved problems. The Institute's position also contrasted with the position adopted by its British counterpart on similar changes eventually rejected by the United Kingdom parliament. A look at its submissions to the select committee reveals that no attention was paid to the very substantial economic scholarship that can be brought to bear on corporate governance issues. There was little appreciation of the costs to shareholders of the inevitable recourse to expensive insurance, and of the routine back-covering involvement of professional advisors in hard decisions. The chickens are coming home to roost, and I see the IOD is now pressing for higher directors' fees in recognition of the increased risks. This seems to me an issue on which it has let down its members and shareholders generally.

Another such issue, and one that is still alive, is takeover regulation. In one sense it is not surprising that an organisation representing directors has joined those clamouring for takeover law. Around the world incumbent managements and boards are usually keen to erect barriers to takeovers in the interests of self-protection. Such laws buttress their position against the rights of shareholders to sell out freely to people who might bring about changes. But if it is good enough for the Business Roundtable, an organisation of chief executives, to take a view based on serious research on the subject and on the interests of shareholders and the wider economy, it ought to be good enough for the IOD to do the same.

In New Zealand the debate has been clouded by a good deal of ignorance. Few New Zealanders realise, for example, that in the most significant jurisdictions of the United States, major shareholders are free to transfer controlling shares privately. There is no automatic requirement to make a simultaneous offer to small shareholders. There is no rule requiring the payment of equal prices to all shareholders in a takeover. Yet the impression has been created that New Zealand is internationally out of line, and even likely to become a pariah for not having such rules. They are, in fact, distinctive features of takeover law only in Australia and a handful of other countries. Not many of us would look to Australia as a model in commercial law.

Much has been said about protecting minorities, but research shows that most New Zealand takeovers make minorities better off. Some people have suggested that takeover regulation is essential to restore overseas confidence in our market. Such confidence is hardly a matter for concern when the facts are that overseas investment in New Zealand shares has doubled over the past four years and now represents about 50 percent of the total equity market. Institutions are accused of pursuing self-interest when they support a more open takeover regime. However, institutions are the 'lead steers' in establishing share values and they have the greatest incentive to monitor company performance, to the great benefit of minority shareholders. The concern for the interests of minority shareholders is legitimate, but the best safeguards for them are sound commercial laws of general application and an open market for corporate control.

Takeover law has been the wrong focus of attention in the battle against fraud and other forms of looting. This has been confirmed by none other than the chairman of the Takeovers Panel, with reference to the London Pacific case. By confounding the two issues we run the risk of adopting a takeover law to deal with fraud, when in fact fraud should be tackled wherever and whenever it occurs.

The Institute made a flimsy two and a half page submisson on the draft takeovers code compared with a fifty page submission and four separate papers by the Business Roundtable. I understand that the Institute also felt able to conclude that the choice the Stock Exchange now proposes to give to shareholders "is not workable" without making any enquiry of the Exchange as to its experience with the administration of analogous provisions since 1989. Many of you will have seen only press reports of the proposals of the Exchange. I have obtained for you copies of the rather thoughtful explanatory statement prepared by the Exchange when it released its proposals for discussion, and a useful article on the debate by Amnon Mandelbaum. I commend these for your careful attention. In my view, the general thrust of the proposals is sound, and they represent a more satisfactory, New Zealand market-based approach to the problem than one modelled on the London code.

It is, of course, the case that people often start with different perspectives on business law and other economic policy issues. Within Fletcher Challenge, for example, there are different views on takeover regulation. The only way to get to the bottom of an issue is by research and careful analysis. During my time as chairman of the Business Roundtable, we began the process of bringing to bear on policy issues the best research and expertise we could lay our hands on. Usually this provided a reliable guide to policy conclusions and, as in the case of the IOD in Britain, it has contributed to shaping the public debate.

I agree with Roderick Deane's conclusion that, with a set of major law changes now behind us, the immediate task is to make them work effectively while taking stock of the outcomes and analysing their weaknesses. He called for the New Zealand Stock Exchange, the Business Roundtable and the Institute of Directors to initiate joint projects in order to identify problems as they emerge and propose remedies. I endorse that suggestion. There are many specific issues crying out for intelligent and objective review.

For a start, there are the new personal liabilities imposed by the Resource Management Act and the Health and Safety in Employment Act, as well as the Companies Act. Is potentially unlimited personal liability a sensible way to enhance health and safety, or does it lead to a waste of resources in transfer payments to insurers and to lawyers and other professionals who profit from the resolution of claims? Does it foster a level of precaution and risk avoidance that bears no relationship to the priorities which people (including potential victims of carelessness or dangerous premises) would attach to the various remedies?

In another area, all managers of businesses should be concerned about the impossible position created by the judges in labour disputes. We are now personally liable if we allow those under our authority to continue to perform their roles when we have any reservations about their competence or willingness to comply with policies and instructions. On the other hand, the Court will afflict us and our companies with very serious costs if we fail to follow a charade of procedural steps to demonstrate 'fairness' in dealing with an employment problem. The Court may think it is protecting the interests of workers by making such decisions. The reality is that workers (and the unemployed) as a whole are penalised as firms factor these employment risks into their decision making.

Jenny Morel, the president of the Wellington branch of the IOD, added to this list in a recent talk. She spoke of the "daunting" compliance costs also arising from the Building Act, the Financial Reporting Act, the Fair Trading Act, the Privacy Act and the Consumer Guarantees Act.

Finally, and perhaps of greatest substance, there is a case for a review of the overall quality of the output of our legal system and its size. Something is wrong when the number of lawyers increased by 50 percent during the last decade when New Zealand's economy hardly grew. As responsible business people and responsible citizens, we should be asking what is happening to the certainty and commonsense predictability that used to be the hallmark of our English-derived law. Should we be urgently looking at the implications of the removal of our right to appeal to the Privy Council if our own legal system has ceased to inspire confidence even among lawyers?

I suggest there is a large agenda for the Institute to get its teeth into. The cost and quality of our business laws are important factors in making New Zealand a competitive economy and an attractive location for investment. They are within the power of our own policy makers to determine. The Institute has rejuvenated itself in recent years with its educational programmes, publications, seminars and a healthy rise in membership. I hope it will do the same in its role of contributing to the development of better business law.

NEW ZEALAND SOCIETY OF FARM MANAGEMENT
SEMINAR
'DAIRY INDUSTRY: SHAPING YOUR FUTURE'

DAIRY INDUSTRY RESTRUCTURING

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20 MAY 1994

DAIRY INDUSTRY RESTRUCTURING

It's now almost two years since the New Zealand Business Roundtable published ACIL's research into New Zealand agriculture's regulatory arrangements, including those in the dairy industry. ACIL's dairy industry work focused on two major issues:

- the implications of paying farmers a 'bundled' return for milk; and
- controls over dairy exports and the New Zealand Dairy Board's single seller monopoly.

ACIL concluded that these arrangements were not in the best interests of dairy farmers, the dairy industry or the New Zealand economy.

Today I intend to concentrate on the issues of industry structure which are currently being widely debated. I will also make some comments on export regulation because it is an equally important issue for dairy farmers.

At the outset I have to tell you that **none** of the major changes the industry is proposing will, on their own, effectively deal with the distortions and problems our research identified and you are now experiencing. Some of the proposed changes will have no beneficial effects at all. My aim is to help you understand how I reach these conclusions and what I think you should do instead.

Before moving to the detail, I must also say how gratifying it is to see you debating the industry's arrangements. It seems like only yesterday that ACIL's research was being labelled "theoretical" and "academic nonsense". Bundling, it was said, was trivial and a non-issue. It is now clear, and widely accepted, that those initial reactions were wrong. The need for change is becoming acute and has to be faced up to. I agree totally with John Boddy who has said dairy farmers should "take a deep breath" and consider the options carefully.

Let me turn first to the bundling issue and the changes being proposed to do something about it.

The price farmers receive for milk bundles together two quite distinct returns:

- the market returns for the products made from the milk; and
- the returns - effectively the dividends - from off-farm investments in dairy processing and marketing.

Of course, the milk return component is also a bundle of different returns from different markets. However, it is best not to introduce this additional complication here.

To understand why bundling is so bad for farmers, and to design effective solutions, it is useful to start by reminding ourselves how farmers respond to output prices.

When farmgate returns rise, milk production tends to rise, and when returns fall, industry output generally contracts. This is hardly a discovery - just confirmation that, like the rest of us, dairy farmers respond consistently and predictably to output prices. They are always trying to make as much farm profit as possible.

Now, if the farmgate milk price includes returns **additional** to those received for the products made from the milk, it is fairly self-evident that dairy farmers will make the wrong milk production decisions. The return the farmer is responding to is more than even the **average** return obtained for all the milk produced. Farmers will be misled into producing milk which, while it might appear profitable for them individually, is sold at a loss and pulls down the profitability of all dairy farms.

At the time ACIL's research was published this logic was not generally disputed. However, most in the industry argued that the impact was very small. I have always disagreed with that conclusion. The significance of the impact is now being more widely recognised.

Recent research by Ireland, Wallace and Associates indicates the impact of bundling is even bigger than originally estimated by ACIL. Their work suggests that dairy farmers have around $4 billion invested off-farm in cooperatives and the Dairy Board. The Dairy Board has agreed this is a reasonable ball-park figure.

This latest work suggests that somewhere between 25 and 33 percent of the payout price would be a return on investment, depending on whether the Dairy Board is an average or a top performer.

I suggest the individual dairy farmer thinks about it this way. Assume you want a 12 percent return on this off-farm investment of $4 billion - which is about $300,000 for the average farmer. The dairy farmer should get an investment return, before receiving any income from milking cows, of about $36,000 a year. Deduct that figure from annual net income and you have a useful estimate of how much was actually received by the average dairy farmer from milking cows.

The answer may shock you. As I said earlier, bundling misleads dairy farmers into thinking milk production is profitable when in fact some of it is not. I have little doubt that much of the current expansion in new dairy farms is, from an industry and national perspective, loss-making production. As Morris Roberts, the recently retired chairman of Kiwi, has said: "There is little sense increasing production when the end result is either static or lower net incomes to farmers. " We are seeing the equivalent of sheepmeat production which was artificially stimulated by SMPs resulting in product that had to be rendered down into tallow. Because of bundling, all dairy farmers are sharing this loss, and it is increasing because milk production is increasing and the Dairy Board and your cooperatives are increasing their investments.

One suggested solution to the bundling problem is to make the farmgate price signal more explicit. The Dairy Board has suggested splitting the farmgate return into two components - a dividend cheque and a milk cheque.

This will change nothing. You could split the payment into as many components as you like. Such changes will still mean that the only way of receiving the off-farm dividend is by producing milk. Farmers will add the amounts together and, on the basis of the total, decide whether it is profitable for them to expand production or enter dairying. The essence of the bundling problem is this link between milk production decisions and off-farm investment profits. You will not solve the bundling problem at source unless you break this link.

It is essential that dairy farmers be able to make separate and independent decisions on how much to invest in dairy farming and how much to invest off-farm.

Another change being suggested involves cooperatives charging those expanding production, or choosing to enter dairying, an 'entry fee'. The idea is to have them pay for the extra processing capacity necessitated by a higher milk flow.

This suggestion is an indirect form of production control. Instead of addressing the bundling problem directly, the idea appears to be to make it more expensive - less profitable - to expand production or enter the industry. There are at least two important issues the industry should consider when assessing this proposed 'solution.'

First, if existing farmers want to stop the loss-making expansion which is pulling profits down across the industry, the entry fee will have to be high enough to stop expansion dead in its tracks. Anything less will, at best, only mitigate the effects of bundling rather than solve the problem.

Alternatively, if, even after allowing for the entry fee, the bundled return means dairying is still more profitable to farmers than the next best form of farming, production will keep expanding as though nothing had changed.

While existing farmers may have avoided the one-off capital contribution for the processing expansion made necessary by the extra milk, this milk will be sold at a loss to the industry, and that loss will reduce the profitability of all dairy farmers.

The second problem with the entry fee idea is that any form of production control, even one as indirect as this, has significant implications for the future structure of dairy farming. It introduces a new set of distortions affecting where milk is produced and who produces it.

Take a few examples. The most efficient farmers, who are frequently the ones with expansion ability and ambitions, suddenly face a new barrier to entry. How can it be in the interests of the industry to block the expansion of the more efficient farmers in this way?

Farmers thinking about another farm so their children can continue the family business will face the same barrier. Sharemilkers will suddenly find the goal posts have been shifted when they were just about to score.

Any form of production control, other than the correct price signal, will create another set of distortions in your industry's structure. Trying to control production indirectly will almost certainly move you from the frying pan into the fire.

Let me now turn to some points that relate specifically to the Dairy Board. There is a proposal that the Dairy Board should be corporatised with the cooperatives being the shareholders. Apparently the objective is to protect farmer and company ownership of the Board's assets. It has been suggested that a different structure could help retain the single seller status and keep the dairy industry in farmers' hands.

That suggestion has some logic, even if it is not the ideal solution. But following that line of thought, what I can't understand is why dairy farmers themselves should not be the shareholders, and why they shouldn't be allowed to trade the shares. Alternatively, farmers could hold conventional shares in the cooperatives who would, in turn, be the Dairy Board shareholders.

At the very least such options would break the link between the farm investment and the off-farm investment. This change is essential if you are to solve the bundling problems once and for all. It would create organisations which have share prices and pay dividends so you could see more clearly how well they are performing. If total farmer ownership is to be sacred, then restrict share trading to dairy farmers.

The downside of restricting ownership is that you also continue to restrict capital sourcing to dairy farmers. This may not have been a problem in recent years but it was in earlier times and will be so again with the improved growth outlook for the economy and the industry.

Many dairy farmers appear to have a morbid fear of allowing anyone else to invest in the industry. It is a self-imposed constraint that simply doesn't make sense.

I find it curious that an investor like Heinz is seen as bringing advantages to New Zealand, and the rural industries it is involved with, while the dairy industry views companies like Nestlé as the enemy. I would have thought dairy farmers would want as much capital and expertise as possible being attracted to their industry. After all, the most important influence on the milk price is how much competition there is to buy your milk.

However, I also recognise that many dairy farmers feel very strongly about preserving the cooperative structure of the industry. There is a second best alternative which would accommodate their concerns. Instead of focusing on the preservation of the cooperative structure as it currently exists, I suggest you focus on options which allow you to keep the attributes of this structure which many seem to value while making the necessary structural changes. By attributes I mean the apparent desire to maintain farmer control of your 'vertically integrated' industry arrangements.

Many of you may have already heard of the Wesfarmers model. I suggest you look at it closely as a potential solution to the problems being discussed.

Wesfarmers started life as a rural marketing and supply cooperative in Western Australia. It is now one of Australia's larger rural and resource companies and is still majority owned by farmers.

What the cooperative did was to float the business publicly, while retaining farmer control through a founder's share owned by the cooperative. Farmers have maintained majority ownership both through the cooperative and by being free individually to buy listed shares in the company.

This structure has been very successful in attracting competent management and non-farmer equity. Investors, including farmers, are attracted by its good performance which is clear for all to see through a market-determined share price and dividends. For these reasons, majority ownership by producers has not dissuaded others from investing.

While I personally favour full corporatisation, I believe the Wesfarmers model is a solution which would be superior to most of the solutions currently being advanced within your industry.

A decision to adopt the Wesfarmers model for the Board and your cooperatives need not involve removal of the single seller arrangements. However, I think you should look more carefully at whether the current restrictions on exports are really in the industry's best interests, let alone those of the country as a whole.

In some markets, and for some products, there are clearly advantages in being big. However, it is wrong to simply conclude that this means a single seller monopoly is necessary. Forestry companies are generally big for commercial reasons, not because governments legislated to make them so.

Your single seller Board is not a monopoly in any practical sense when operating in the international market. To be a successful monopoly an organisation has to be able to exercise effective monopoly power by restricting supplies and forcing up prices in a sustainable way.

By definition, monopoly power - and therefore monopoly benefits - do not exist when there are others producing the same products or adequate substitutes.

Some months ago the President of Federated Farmers said:

> ... monopolies are not good when we have to buy from them.

Dairy farmers need to recognise that, in a very real sense, they are buying from the Dairy Board. They are buying marketing services.

The Board takes the producer's output, markets it, deducts all the costs, and returns what is left to the farmer. The amount the Board deducts is the price the dairy farmer has paid to have output marketed. The fact that it is deducted rather than charged is immaterial. It is a cost for a service the farmer buys - in fact, is compelled to buy.

Dairy farmers have no ability to use competition to minimise this cost. The President of Federated Farmers hit the nail on the head when he said monopolies are not good when you have to buy from them.

When was the last time you saw a monopoly exposed to competition and found it was minimising costs and maximising efficiency? The Apple and Pear Marketing Board has had to compete in the domestic market this year and it has lost a large part of its market share to competitors who, in the eyes of growers, were able to do a better job. I have constantly argued that the industry's single seller arrangements deliver no monopoly benefits but undoubtedly incur monopoly costs.

Even if you don't accept this argument, and I know there are some who never will, you must at least consider how long you can hold the line on restricting exporters, and how well prepared you are for what I regard as inevitable changes.

I'll conclude my remarks by commenting on these issues.

It is said the industry wants to sort out its arrangements without any interference. Ultimately that position is unsustainable - overall national interests must prevail. However, the stage has been reached where I see one major impediment to the industry working out its own destiny quickly and successfully. That impediment is the 'deity status' you continue to give to the single seller export arrangements.

Many in the industry exhibit a blind adherence to the view that without the single seller the dairy farmer will be ruined. Our research suggests exactly the opposite. In fact, I think that once it has gone we will see one of the most exciting eras in New Zealand agriculture.

I know there are many in the industry who agree with ACIL's reasoning and conclusions. However, they are not speaking out for fear of being excommunicated. This is a very sad state of affairs and one for which you will pay dearly if attitudes don't change quickly.

Even if you still believe in sacred cows, please think carefully through the implications of the economic and political pressures now building up in your industry.

- The bundled return is encouraging more production which requires more capital to process and market. Until you unbundle properly, these trends will continue to increase the pressures for change.

- If you try to slow down or stop production increases and new entrants you will you get a backlash from those disadvantaged by such barriers. More and more people who want to stay in, or enter, dairy farming will realise it is to their advantage to separate farm and off-farm investment decisions. Sooner or later the government will also have to come to the party because regulated production controls are not in the national interest. Too many independent parties, including the government's own advisers, are pressing that argument for it not to succeed.

- When allowing outside investment becomes unavoidable you will find few commercial interests that are willing to invest if they are not also allowed to export. There will also be pressure from existing dairy companies who see opportunities to be more successful if they could enter into joint ventures and sell their innovative products directly instead of sharing the proceeds with everyone else.

These types of pressures are already evident. If you don't reform the arrangements *in toto* the pressures will continue to build up and your ability to manage the changes will diminish.

Look carefully at the Wesfarmers model. It is a very successful working example well suited to most of your objectives. Most importantly, it represents the type of structural change you should be making to ensure you are prepared for the demise of the single seller monopoly. Eventual deregulation is now most likely to come from pressures within the industry itself. How well those pressures are managed will depend critically on how quickly the industry starts discussing publicly what is being discussed in private.

SUBMISSION BY THE
NEW ZEALAND BUSINESS ROUNDTABLE
TO THE MINISTRY FOR THE ENVIRONMENT ON THE
CONSULTATION DOCUMENT

EXPLORING THE OPTIONS FOR REDUCING NET EMISSIONS OF CARBON DIOXIDE

APRIL 1994

EXPLORING THE OPTIONS FOR REDUCING NET EMISSIONS OF CARBON DIOXIDE

1 Introduction

On 18 March 1994, the Ministry for the Environment released a Consultation Document ('the Document') entitled 'Exploring the Options for Reducing Net Emissions of Carbon Dioxide'. It described a range of measures which could be used to reduce carbon dioxide ('CO_2') emissions and noted that the government sought comments on these measures "to help in the design of policies for its consideration".

The measures canvassed in the Document included:

- a tradeable emission permits scheme;
- a carbon charge scheme;
- either of the above, in combination with the government's Energy Efficiency Strategy and other measures - such as information programmes and voluntary agreements; and
- negotiated agreements to reduce emissions.

Officials are working towards having a package of complementary emission reduction measures in front of the government by mid-1994. Such measures, and their time of implementation, would "inevitably be linked to the actions of other countries under the Framework Convention on Climate Change" ('the FCCC').

Section 4 of the Document sets out sixteen explicit questions. Specific answers to these questions are sought to "assist officials to evaluate and refine policy measures". In particular, officials desire to find out how business costs, investments, levels of output and employment, use of fossil fuels and CO_2 emissions would be affected by each of the above measures. Eight questions specifically relate to a carbon charge scheme and/or to tradeable permits. Six more questions cover negotiated legally binding emission reduction agreements and/or cooperative programmes and/or distributional and environmental effects. The fifteenth question concerns possible additional features of an emission reduction programme. The final question concerns timing. The Document encourages respondents to organise their responses around these questions.

In the next section of this submission, we set out our general response to issues raised by the measures proposed in the Document. A third and final section responds specifically to the questions posed in section 4 of the Document.

2 General Comments

The New Zealand Business Roundtable supports a 'no regrets' policy to the global warming issue, defined to mean that New Zealand takes no action at present which cannot be justified independently of global warming issues. In taking this position, we acknowledge the case for coordinated international consideration of this global externality issue and agree that it is desirable for New Zealand to play a constructive role in this process.

In our view, the following considerations should shape New Zealand's role:

- the fragility of the scientific evidence concerning the relationship between CO_2 levels in the upper atmosphere, anthropogenic emissions, and global warming and its climatic effects;

- the uncertainty about the degree to which New Zealand would be beneficially or adversely affected by global warming;

- the limited nature of likely initial actions by other signatories to the FCCC, given their concerns about international competitiveness and the political difficulties of imposing costs on their home populations while global emissions continue to grow quickly as industries shift to, and develop in, third world countries;

- the need to resist, in international forums, any undue emphasis on reducing gross rather than net emissions;

- the relative importance to New Zealand of the issues concerning carbon sinks, methane emissions, the export of coal, and the mix to be found between water-, thermal- (gas or oil), nuclear-, wind- or solar-based sources of additional electricity generation; and

- the degree to which time is on New Zealand's side in that we are likely, primarily because of our carbon-absorbing activities, to do far better than most countries in meeting the FCCC target for net CO_2 emissions for the year 2000.

Given their political constraints, many signatories are likely to announce a large array of measures many of which will be notable for their uncertain impact on carbon emissions. Elements of posturing and perversity are likely. *The Economist* recently observed (19 March 1994) that:

> ... [s]ome see all this [the FCCC] as inspiring proof of a new commitment to saving the environment. In fact, it merely shows how easy it is for politicians to sign bits of paper - so long as they will be safely in retirement when the time comes to take action. ... When the industrial countries start to consider seriously ways to reduce their output of greenhouse gases, they will ask some awkward questions. They will want clearer scientific evidence that the accumulation of greenhouse gases really changes the climate and, if so, whether the change carries appreciable economic costs.

Certainly, developments to date suggest little likelihood that the major countries will take sufficiently vigorous action to allow quantitative targets for the year 2000 to be achieved. New Zealand should do its best to avoid perverse measures (i.e. ones which would increase net emissions while having no economic benefits), both locally and internationally, but, as noted in the Document,[1] it should not move ahead of other countries on policies of substance. As scientific evidence on the issue accumulates, the quality of any case for faster action will become clearer.

At present New Zealand has two problems. We need to:

(i) handle our international relationships vigorously and effectively. We should develop effective strategies for minimising the effects of perverse developments on New Zealand, particularly in respect of a focus on gross rather than net emissions. Opportunities for international trade in carbon credits could benefit

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1 Refer to p 7.

New Zealand and the world. We should also resist the exploitation of the compensation issue as a device for transferring wealth in favour of third world countries generally. That is a different debate. Consideration of whether New Zealand is likely to be a net beneficiary or a net loser from global warming is important in relation to our position on the compensation issue; and

(ii) determine the optimal package of domestic measures in relation to New Zealand's FCCC and other commitments.

Industry in New Zealand is concerned that the government and officials do in fact handle the international aspects of the problem vigorously and effectively. Since the Document focuses on the second problem, we will not dwell further on the international relations aspect in this submission, but its importance to industry should not be ignored.

In respect of the second problem above, the Document focuses on measures which go beyond a no-regrets approach. We do not dismiss the merits of such an approach *as a contingency strategy*. Indeed, to the degree that the optimal contingency strategy can be accurately determined, an outline of its main features could reduce business and consumer uncertainty, aid forward planning and reduce future adjustment costs.

However, we have two reservations about this focus in the Document. The first concerns the limited basis we have at present for determining the optimal contingent strategy. The second concerns the need to ensure that opportunities for implementing policies of a no-regrets nature are not down-played.

In respect of the optimal contingent strategy, much depends on detailed consideration of the costs and benefits of the two broad alternative approaches (charges or permits) and their variants. Integration of domestic and international systems could be a factor. A properly informed choice is likely to be conditional on further analysis and international developments.

Much remains to be done under a 'no-regrets' approach. Some measures are entirely a public sector responsibility while others may involve both the private and public sectors.

In the public sector, the government currently has full ownership responsibilities for all matters affecting the price of electricity generation and transmission. Prices should be allowed to reflect the full marginal cost of additional generation for both environmental and efficiency reasons. Artificially low prices reduce incentives to conserve electricity and bring forward the environmental issues concerning sources of additional generation. Subsequent government-imposed energy conservation measures in conjunction with poor quality regulatory structures and/or decisions in respect of water rights, rights to emit gases from thermal generation and nuclear generation could represent a very inferior approach to the problem.

The government can exercise leadership on energy conservation in respect of the activities of the many ministries, departments, agencies and health, educational and other businesses which it variously owns, funds and/or controls. This is a particular issue for the public sector because incentives to find optimal energy savings measures in this sector could be weaker than in the private sector, particularly for activities of a cost-plus nature. Of course, these incentive problems raise much wider issues, so energy conservation measures should not get undue emphasis in this respect.

Another issue for the Crown under a 'no-regrets' approach arises from its ownership interest in coal. The prospect of a future carbon tax on coal surely creates a commercial reason for exporting coal more rapidly in the immediate future before such taxes become a global reality, presuming that world prices have not already fallen commensurately. It is the Crown's responsibility to determine whether or not such an approach would also be in the nation's best interest taking account of its international obligations.

Another clear government responsibility arises from its role as a major purchaser of research services in New Zealand. Given the potential costs of erroneous policies in response to the global warming issue, it needs to ensure that its research funding priorities reflect its priorities in relation to that issue. Is it possible, for example, to obtain more guidance as to whether or not New Zealand would benefit or lose from modest global warming? Is the government doing enough research into the issues raised in the Document?

Tax and regulatory policies also deserve consideration under a 'no-regrets' approach. In the transport sector, the government runs the national highway system and determines the pricing of this system through road user charges and petrol duties. It also imposes excise duties on motor vehicles and assists the domestic assembly industry through tariffs on imported cars. Given that burning fuel is a significant source of CO_2 emissions, consideration should be given to the optimality of the existing arrangements, even under a 'no-regrets' approach. Currently, road user charges do not include a cost recovery element for the accumulated investment by central and local governments in the road network, nor do petrol duties which are currently allocated to roads on a cash-expenditure related basis. The optimality of the existing road pricing system and vehicle-related tax structure more generally needs to be assessed, independently of any global warming issue. This work needs to be undertaken before any carbon tax is applied to that sector. Beyond the transport sector, the tax system should not, without good reason, unduly favour or inhibit petroleum or gas exploration, forestry plantations, livestock production or particular forms of electricity generation. In the regulatory area, the implications of the CO_2 and methane issue for the operation of the Resource Management Act need to be considered.

In our view, the first moves beyond the government's present approach should involve:

- a review of the government's activities as owner and purchaser of resources; and
- voluntary, cooperative consultations with the private sector.

Included in any such review of the government's own activities should be the Department of Conservation and the Land Corporation since they control a major portion of New Zealand's land area. The optimal land use in respect of forestry regeneration and livestock production may change if it is more desirable, at the margin, to manage the land as a potential carbon sink. There may also be implications for the management of native forests. Consideration may need to be given to the departments' incentives to take advantage of carbon sink opportunities. On international aspects, the government has an opportunity to consider if its foreign aid programme could be better targeted in respect of this issue. A more active approach to emissions management could alter the optimal coal export strategy and the constraints applying to non-thermal electricity generation.

In relation to measures affecting the private sector, beyond those of a 'no-regrets' nature, we suggest that an optimal current response to the government's commitments in relation to global warming would have the following components:

- no commitments, even of a contingent nature, to *implement* coercive measures (such as carbon taxes or permits) given the severe lack of information at present concerning their optimal levels or even their desirability;

- clear government acknowledgment that measures to increase carbon absorption are as valuable in terms of global warming effects as measures to reduce carbon emissions, and that equal recognition will be given in principle in respect of (sustained) carbon sinks. The government should also make it clear that those owning methane-emitting production processes should be more concerned per tonne of emissions than those owning CO_2-emitting processes. The current emphasis on CO_2 emissions is undesirable for both efficiency and environmental reasons;

- industry and farm sector consultation concerning the scope for non-coercive measures (see below); and

- efficient discharge of government responsibilities in respect of the sorts of proposals concerning energy efficiency and conservation which are canvassed in Appendix D of the Document.[2] This includes the avoidance of coercive energy conservation measures which are based on the premise that the government has superior information about future energy prices.

In respect of the last point, it is not desirable, in principle, to impose costs on producers which are unrelated to their task of meeting the needs of consumers of their products at least cost. To force on an electricity producer, for example, the dual role of producer of electricity and promoter of energy-conserving investments is to confuse its incentives. Others (e.g. retailers) who do not have a conflict of interest can market energy-conserving investments to consumers.

In general, the costs of providing such information should fall on those who seek to profit from it, because they have the best incentive to accurately evaluate the benefit to consumers of that information. In the case of cars, those who seek to profit by selling more fuel efficient cars will also be in a good position to judge, from the public's response, what value they put on that information. The Consumer's Institute may also see a role for itself here. It is not obviously desirable to impose on producers of powerful cars labelling requirements which are aimed at encouraging consumers to buy more fuel efficient cars. Many of the activities listed in Appendix D of the Document are of concern from a public policy and industry perspective.

In respect of the benefits from wider industry and farming organisation consultation, it is important not to underestimate the scope for altering business decisions and the climate of opinion by leadership by example (as above) and by the provision of information. Arguably, this task has scarcely begun. Most livestock farmers, for example, are probably largely unaware of their exposure to the global warming issue. In addition, there is little evidence of progress in respect of many of the areas listed above which are a clear public sector responsibility. In particular, the failure of the government to permit efficient pricing of electricity is causing major structural problems in that sector and needs to be corrected.

Non-coercive discussions with farmers and specific industries would heighten awareness of these issues and could induce voluntary actions to reduce emissions.[3] Presuming that the case for action in respect of global warming becomes more

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2 Refer to Jerry Taylor, "Energy Conservation and Efficiency: The Case Against Coercion", *Policy Analysis*, No 189, The Cato Institute, 9 March 1993, for a wide-ranging discussion of the potential for policy mistakes in this area in the United States.

3 Of course, as noted in the comments above on coal, apparently perverse outcomes are possible if the optimal response is to emit sooner rather than later. This is not an argument against consultation.

convincing in time, incentives will be created for voluntary action. This could occur where the costs of actions to reduce emissions or increase absorption are very low and some benefits exist. The benefits could be either of a public relations nature (as when an emitter simultaneously invests in a carbon-absorbing activity) or akin to the benefits of buying insurance. Some farmers, for example, could reduce their exposure to the risks of a future carbon tax by deciding at the margin to invest in trees or crops rather than livestock.

Incentives to reduce emissions voluntarily increase if public opinion is mobilised. The feeling that conservation is desirable creates decentralised incentives to be seen to be doing the right thing. Thus consumer demand for organic foods and recycled paper has led to their supply. More generally, the possibility that greater transparency concerning emitting and absorbing activities could alter norms of behaviour has been discussed by Victor.[4] The development of such norms could be in accord with the voluntary, cooperative approach mentioned on page 10 of the Document.

In short, the thrust of this submission is that the government needs to consider a far wider range of measures than is considered in the Document and to put much less emphasis at this stage on coercive measures affecting the private sector. No convincing case has been put to the community that the problem warrants the announcement of any intention to implement coercive measures. Electricity pricing and the application of the same considerations to methane as are being considered for CO_2 could be key tests of the government's ability to implement any worthwhile initiatives in terms of the global warming issue.

Nevertheless, if the government determines to move towards a carbon tax or permit system, the foregoing considerations suggest that the tax should be at only a low rate or that the allocation of permits should be generous. For such an approach to be consistent with the full achievement of its overall targets, the government would be relying initially on a combination of new forestry plantings, cooperative solutions (which would include specific public sector measures) a range of other measures (such as electricity pricing) and a particular projected path for economic growth. It is difficult to believe that New Zealand would stand out from other countries in any of these respects. Instead it could stand out for the quality of its measures, the probability that it will actually achieve its targets and for its rigour in encompassing methane (and other) emissions when few other countries are likely to be doing so. It could also point to many past decisions taken primarily on economic grounds (e.g. reductions in agricultural subsidies, improved efficiency in state-owned enterprises and the imposition of a consumption tax (GST) on energy products) which mean that New Zealand has done more than many other countries to curb emissions of greenhouse gases.

The next section responds directly to the questions posed in section 4 of the Document.

3 Responses to Questions in Section 4 of the Document

Questions 1, 2, 3 and 4. [Concerning the effects on activity levels and emissions of a carbon charge or permit]

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4 David Victor, "Practical Aspects of Implementing Greenhouse Taxes: Issues for OECD Countries", Chapter 14 in Climate Change "Designing a Practical Tax System", OECD 1992.

These effects will be firm and/or industry specific and are best commented on by members of the New Zealand Business Roundtable in respect of their own organisations.

Question 5. "Do you consider a tradeable permit scheme is workable given the structure of the fossil fuel supply market in New Zealand?"

In principle it should be, but taxes are workable too. In practice, so many uncertainties and difficulties would arise in its implementation as to raise grave doubts as to its usefulness. As noted in section 2, broad transport pricing and tax policies need to be considered in relation to fossil fuels. Given the certain costs of any permit system and the highly uncertain benefits, there is an uncomfortably high probability that the costs would greatly exceed the benefits for the foreseeable future. The Tasman Institute has expressed the view[5] that the cost benefit equation would be improved if there were clear rules permitting international trade in carbon credits and permits. These have not yet been established.

Question 6. "How does the way permits are allocated affect your views on such a scheme?"

The allocative method chosen should alter the distribution of costs and benefits rather than the totals. However, all allocative methods would be politically difficult, some more so than others. Tendering would appropriate rents from sunk cost situations. Administrative allocation would attract rent seeking. Grandparenting at 1990 levels could disadvantage recent entrants and it would not avoid immediate economic costs. All methods would require the government to table much more convincing evidence than has been provided to date concerning the scale of the hoped-for benefits from carbon taxes or permits.

Question 7. "How are your views on a permit scheme affected by how quickly the scheme constrains emissions to grow more slowly than business-as-usual predictions?"

The faster the required speed of adjustment, the greater the likely transitional costs. (Refer also to the answer to question 16 below.)

Question 8. "To achieve a given reduction in emissions, would you prefer a package of measures which included tradeable permits or included a carbon charge?"

This question presumes that coercive measures to reduce gross emissions in New Zealand are desirable. This case for such a departure from a 'no-regrets' approach has yet to be made.

Answering this question satisfactorily would require a lot of research. Trading in permits establishes an equilibrium price which is consistent with the quantity of permits issued. A tax, set at the price at which permits would trade, is consistent with the same quantity. At a high level of generality, the two approaches are virtually equivalent.[6] There appears to be a lot of confusion over this point. It is not uncommon to see arguments put forward in favour of permits which apply equally to a tax. The

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5 Tasman Institute, "A Framework for Trading Carbon Credits from New Zealand Forests", Report C6, March 1994.

6 Victor, op. cit., explains this point formally on p 105.

choice between these two approaches must therefore be made on the basis of finer points of distinction, such as those arising from uncertainty, implementation costs and practicalities.

Uncertainty is a point of distinction because a charge approach offers more certainty about price, but less about quantity, than a permit approach. Superficially, therefore, the current FCCC and the New Zealand government focus on quantitative targets favours a permit approach. However, as the OECD has noted,[7] "this difference between the two systems is not particularly important for the greenhouse problem".[8] The "key advantage ... that the reduction in the emissions would be certain" claimed in the Document[9] for permits is therefore illusory from an economic or environmental perspective.

The essential point here is that there is little virtue in being more confident about achieving an arbitrary quantitative target. The quantitative targets in the FCCC have been reached as a result of political processes in which the costs of achieving those targets have been neither identified, nor agreed to, by the signatories' constituent electorates. In the current situation, we have no particular information as to what is the optimal quantitative target or carbon charge for the world, the signatories to the FCCC generally, or New Zealand in particular. There is a high probability that any quantitative target currently set for reduced emissions will be suboptimal from a global warming perspective. Nor is the amount of emissions in any one year of great significance. Hence the fact that a permit scheme provides a higher probability of achieving a *given* quantitative target than a tax scheme may be of little economic benefit - even if the target is achieved. A further point is that a carbon tax could be imposed and increased over time as desired according to the evolving path of emissions.

An important concern with a permit system is that, as the Document notes, the price at which the permits will trade is not known in advance. If it turns out to be much higher than expected (e.g. because economic growth is much higher than expected) then the costs of abatement could be much higher than expected - unless the quantity of permits on issue is increased. But to announce that the government would increase permits in such an event, while in accord with its desire to improve international

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7 Victor, op. cit., p 104.

8 Economic theory suggests that, at a high level of abstraction, a permit-based approach might be preferable to a charge-based approach if the benefits from abatement rise faster than the uncertain marginal costs. For example, if gas being released into the atmosphere is non-toxic up to a certain level of concentration at which it becomes lethal, whereas the cost of abatement is relatively steady, then a permit-based approach to avoiding lethal concentrations could be the more efficient. In applying this insight to the global warming issue, the marginal reduction in global warming from reductions in gross emissions by New Zealand is clearly minimal and, arguably, unlikely to be rising. Indeed, to the degree that the benefits to New Zealand from such reductions primarily derive from the international goodwill they generate, they could be falling at the margin. In contrast, the marginal costs of abatement could rise sharply, particularly if economic growth is faster than expected (making permits scarcer than expected) or where domestic processing industries are operating on thin margins in international markets in which they are price takers. Given the uncertainty about abatement costs, there is a risk therefore that a permit-based approach could shift relative prices more adversely than expected, inducing such industries to contract at a national cost which greatly exceeded the national benefits.

9 Refer to p 13.

competitiveness, would be to admit that the quantitative target was not necessarily more important than a price target.

Nor does grandparenting provide an obvious point of distinction between taxes and permits. Existing business activities can be protected under a tax system by applying the tax only to *increases* in emissions. This would obviously be a very complex system to administer on a firm-by-firm or activity-by-activity basis. However, achieving the same protection with a permit scheme is more complex than appears to be recognised in the Document. The Document states,[10] in the context of a discussion about tradeable permits, that:

> Existing investments in carbon-producing plant and equipment would be protected, to the extent that owners of such plant and equipment were issued with permits allowing for their existing emissions (i.e. were grandparented).

This statement is at best misleading. Existing industries will shut down their operations if they are allocated *tradeable* permits whose value to other emitters is sufficiently greater than their value in keeping an existing plant operational. The point is that the method of allocating tradeable permits alters the wealth distribution, it does not ensure the viability of plants. Since the costs to the nation of benefit abatement arise from the costs of having to reallocate resources, not from the reallocation of income amongst residents, the allocation of permits amongst residents will not necessarily affect abatement costs (although allocation to existing emitters could slow the rate of adjustment to the new incentives and disincentives). Even the Tasman Institute, which has a very competent discussion of the permits-versus-taxes question, could mislead readers on this point with its observation that "[p]ermits can be allocated to existing emitters limiting the costs of emissions abatement and circumventing major distributional problems".[11]

Note that existing activities would be protected if the grandparented permits were *non-tradeable* and plant or activity specific. In this case they would have no value in any alternative use and their owner would have no incentive to close the plant down in order to allow the permit to be used in another activity.

Incentives on existing industries to abate could be created under a permit scheme with non-tradeable components by a phased conversion of non-tradeable permits to tradeable permits. A similar result could be achieved under a tax approach by offering a phased subsidy for emission reductions.

Nor does a desire to recognise opportunities to develop carbon sinks obviously favour a permit approach. As the Tasman Institute observed:[12]

> Under the credit system, emitters of carbon dioxide would be able to purchase carbon credits from forest owners. Credits would be delineated in units of weight of carbon dioxide (for example, tonnes or kilograms) and each credit would allow a once-off deduction from annual carbon emission levels. Deductions would correspond to an amount of carbon sequestered in plantations over a fixed time period (for example, one year). *A tax credit system would create a market for carbon sinks which would have many similarities to a full tradeable permits emissions scheme* [emphasis added]. For ease of exposition, the later discussion of carbon sink markets is couched in terms of a full tradeable carbon credit and

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10 Refer to p 15.

11 Op. cit., p 16.

12 Op. cit. p 17.

> permit system. However, the discussion is applicable to hybrid tax/carbon credit systems as well.

Another suggestion for distinguishing between taxes and permits concerns the compatibility of any domestic regime with any international regime. The same Tasman Institute paper noted that an international credit scheme could benefit New Zealand since we could be one of a small number of countries which could have excess credits for sale. For most countries, projected net emissions in the year 2000 exceed estimated net emissions in 1990. The Tasman Institute rightly notes the political difficulties with the universal imposition of an international tax and credit approach, whereas trading agreements in permits could be freely negotiated between countries on a bilateral basis. However, countries could similarly negotiate a common tax/tax credit policy on a bilateral basis. In the end, the Tasman Institute focuses on permit and credit trading rather than taxes on the basis that the integration of such a domestic system with international trading would allow New Zealand to gain the most advantage from participating in international trade.[13]

While this argument may be valid, it would appear to require further substantiation. The theoretical near-equivalence of a domestic tax/permit system extends to the international arena also. Countries could establish a tradeable country quota/credit system. Each country could use whatever domestic instruments it wished to adapt domestic outcomes to the price on the world market for quota. For example, this price would be the correct rate for a domestic tax, if a tax approach is preferred. Victor sums up his conclusions on the issue of the relationship between domestic and international systems as follows:[14]

> As in the case of an international tax, the choice of specific domestic policies may be left to the individual countries under the above system of tradeable emission permits. In particular, a choice between using a tax or some kind of tradeable emission permits at the *domestic* level may be made independently of whether a tax or tradeable permits is used at the *international* level (i.e. between governments). If a tax is used at the domestic level, the optimal tax rate for each country is equal to the international market price of tradeable emission permits (at least in the simplest case of competitive domestic markets without any distortions, and with income maximisation as the only objective of the government).
>
> At the international level, the main advantage of tradeable permits compared to an international tax is that the necessary institutional arrangements are simpler. ... Also, a system of tradeable permits can be introduced into a climate agreement gradually over time: in any agreement with quantitative commitments for emissions for each country, the countries can themselves decide whether and when they want to participate in any kind of trading of emission permits with other countries. An international tax, on the other hand, is more of an "all or nothing" option.

The conclusion we draw from this analysis of the permits-versus-taxes issue is that, while the choice of system may have major distributive effects (and therefore have implications for rent-seeking expenditures), in terms of economic efficiency and environmental outcomes the supposed advantages of a permit-based approach are not self-evident in terms of economic principles.

Beyond matters of principle, we suspect that there will be significant implementation difficulties with either a tax- or permit-based system, particularly if it is accepted that

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13 Op. cit. p 18.

14 Op. cit. p 106.

any charge or tax should encompass a level-playing field approach to CO_2 and methane emissions and sinks. For example, the presumed advantage of a permit-based approach based on the small number of major sources that would need to be included may well evaporate if the much larger number of methane sources are brought into the equation. Consideration needs to be given to the relative costs and difficulties of introducing credit mechanisms into each of these two approaches. This may not be a straightforward matter.

In short, there are many considerations which need to be investigated further before a judgment can be confidently made as to which approach would better serve the national interest.

Questions 9-11. [Concerning legally binding emission reduction agreements and potential involvement in cooperative programmes]

The New Zealand Business Roundtable would not be a party to company- or sector-specific agreements or cooperative programmes. Such agreements would be a matter for its individual members. As noted in the previous section, we believe that any steps beyond a 'no-regrets' approach should focus in the first instance on leadership by example and on cooperative industry and farm sector consultation.

Question 12. "How would you see such programmes working in with the energy efficiency strategy and other measures outlined in this document?"

Cooperative programmes will no doubt be widely used amongst the signatories of the FCCC as evidence of their commitments under that convention. By their very nature, they are also highly unlikely to impose major costs on industry. As such they have the potential to be both internationally acceptable and low cost; they could also lead to some useful energy efficiencies. On the other hand, interest groups would have an incentive to capture such a process so as to expand bureaucracies, and/or raise competitors' costs relative to their own and create barriers to entry at the expense of consumers. The incentive framework for the process and the quality of the people controlling it could have a marked effect on outcomes.

More generally, aside from ensuring that the price of energy reflects the full cost of its production to society, the case for imposing additional energy conservation measures on the private sector is dubious at best. The previous section contains more discussion of this point.

Within the public sector, incentives to respond economically to price signals are weaker than in the private sector, so the case for considering energy conservation measures may be greater. However, the incentive problems within the public sector go far beyond energy conservation matters, so the resources put into such an exercise could conceivably be better deployed in other areas.

Questions 13 and 14. [Concerning the effects on particular groups, communities and regions]

These questions are of a group, community or region-specific nature and could be best answered by individual members of the New Zealand Business Roundtable, or other respondents.

Questions 15. "Are there additional features that you would like to see in any measure, or combination of measures, to reduce emissions? If so, please answer questions 1, 13 and 14 for these as well."

Carbon Sinks

The logic of the global warming case requires absorption measures as well as emissions measures.

Methane

The focus of the Document on CO_2 emissions is undesirable from both a narrow environmental and a broader efficiency perspective. In principle, measures contemplated should certainly encompass methane. Possibly they should also encompass other greenhouse gases. In all cases conventional cost/benefit considerations apply.

Genuine concern with global warming requires a comprehensive approach to greenhouse gas emissions. Failure to apply the measures to methane risks distorting land use decisions. For example, land could be used to rear livestock when global warming effects would be reduced if it were used instead to grow crops or trees. Similarly, such a failure could see methane continue to be emitted by effluent treatment schemes when the impact on global warming might be reduced if the methane were flared to produce CO_2, a less potent greenhouse gas.

From a broader efficiency perspective, it is important that net greenhouse gas reductions are achieved at least cost. It is not desirable to reduce industry emissions of CO_2 if a similar reduction in the global warming effect could be achieved at less cost by diverting some land from livestock production to horticultural or tree-growing purposes. There is no economic or environmental reason for singling out non-farm industries for explicit action.

The only apparent reason for focusing on CO_2 emissions is that this is the current FCCC policy and any political difficulties that may be associated with action affecting the farming sector. In respect of the first point, it should be borne in mind that the present focus is still formative and is not in any case a sound reason for reducing economic efficiency domestically or imposing unnecessary environmental costs. New Zealand would be on sound grounds in terms of domestic economic efficiency and global warming responses if it led by example in this area. The New Zealand Business Roundtable would be strongly opposed to any policy which treated industrial activities and farming in a discriminatory manner.

Role for other government policies

As detailed in section 2, a high level of government intervention already affects most major CO_2-emitting activities in New Zealand. Government ownership is important in respect of coal production, electricity and the pricing of roading services. The government effectively controls both pricing and investment decisions in electricity generation and transmission. The government is a major purchaser of research. It also controls the use of a large portion of New Zealand's land area. In addition, government legislation has a major influence on the ability of industry to obtain permits for alternatives to thermal-based power production - whether water- or nuclear-based. The treatment of wastes is also heavily subject to (local) government interventions. Tax issues in respect of exploration costs and plantation costs may be important in respect of the oil industry and tree planting respectively. Finally, the public sector is itself a major user of resources.

There could be scope for efficiency and/or environmental gains in virtually all these areas. In some cases, better policies from a resource allocation viewpoint could increase net CO_2 outcomes in isolation - which could require imposing greater abatement costs on other activities.

Question 16. "Would you, your business or your community prefer the introduction of:

- **a set of measures with relatively little effect now but with the risk of a requirement for more drastic and sudden reductions in emissions several years hence?**

- **or a set of measures with relatively little effect now accompanied by a binding Government commitment to impose, several years hence, more substantial emission reduction measures with no phase-in period?**

- **or a set of measures which start to reduce emissions now as part of a binding Government commitment to a gradual phase-in period for more substantial emission reduction measures?"**

The first option is the best, because the risks it involves are relatively low. In the New Zealand Business Roundtable's view, it would be premature in current circumstances for the government to attempt to enter into any binding commitments concerning future action for the following reasons:

- the tentative nature of the scientific evidence in respect of climate change implications, and the likelihood that better data will become available in time to consider whether specific policy action is warranted;

- the possibility that New Zealand could be a net beneficiary from global warming;

- the strong likelihood that international action is going to prove ineffective in the face of the weak scientific evidence and the manifest reluctance of OECD signatories to lose industries to fast-growing, third world countries;

- the inconsistency between the government's current 'no-regrets' policy aimed at preserving international competitiveness and any commitments concerning future policies in advance of comparable commitments by other countries;

- the lack of credibility that would surround an attempt now, in the face of such uncertainties, to bind a future government into imposing significant costs on its electorate; and

- the likelihood that we will achieve our commitments, in any case, to a far greater degree than will most signatories.

In the circumstances, given the international competitiveness objective, New Zealand appears to face the choice of going along with the international community, more or less at the community's pace, or moving even more slowly, knowing that our actions will not significantly affect global warming. Following the second oil shock, New Zealand was at the forefront of developing self-sufficiency in energy. The net costs were heavy. The lesson is that governments are bad at judging the course of future events. Their attempts to dictate the optimal pace of adjustment in the face of evolving scientific evidence concerning the costs of greenhouse gas emissions are fraught with hazard.

Under a cooperative approach, firms and industries will look at the problem as it evolves, evaluate their risks and exposures and reduce them where insurance, in the broadest sense of that term, is commensurately cheap. An evolutionary, non-coercive approach seems eminently sensible at this stage.

MISCELLANEOUS

AORANGI CLUB

UNDERSTANDING MARKETS

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

AUCKLAND
16 AUGUST 1994

UNDERSTANDING MARKETS

My aim today is to throw a little light on one of the most extraordinary, beneficial and difficult-to-understand of human institutions, the market economy.

It is extraordinary because, as one of its foremost 20th century exponents, Friedrich A Hayek, often stated, it is the product of human action but not human design. By that he meant that, like another great institution, language, no one invented the market economy. Markets are simply arrangements whereby people benefit by trading, by exchanging things of value to them. They rest on a foundation of private property, voluntary cooperation, mutual reciprocity and human respect. They range from the flea market at Otara to the London futures exchange.

Secondly, markets are a beneficial institution because they have the capacity to raise people from the primitive state of life on earth for millennia to the income levels of today's advanced countries. The living conditions of a small but steadily increasing proportion of the world's population have improved over the last 1000 years, but more particularly over the last 200 years as institutions such as the rule of law, private property and democracy took hold in the West. In our own time we have seen the phenomenal market-driven rise of living standards in Asian countries which little more than a generation ago were as poor as any on earth. We are living in a decade in which the spread of market economics holds out the prospect of ushering in the greatest period of prosperity the world has ever seen.

Thirdly, the market economy is hard to understand. Because it is not a product of human design, it lacks the intuitive appeal of human creations such as the planned economy. Its features are complex, subtle and often counter-intuitive. There is no planning document that tells people how many loaves of bread will be baked, how many computer programmers we should train, or who will build the next power station. The apparent certainty of a government plan that provides the answers to such questions appeals to many people. And the philosophy of market liberals has been under assault from ideologies of the left and right for at least 150 years. I plan to deal with some of the myths that surround market economies.

Let me say at the outset that nothing I nor anybody else can say on the subject will convince some people. A few years ago when Bill Andersen and I were on a Radio Pacific talkback programme, he was asked to nominate what for him was the model society. I was staggered to hear him reply: East Germany. To make quite sure I had not got things completely upside down, I visited East Germany a couple of years later, after the fall of the Berlin Wall.

I found East Germany's leading industrial centre, Leipzig, in a state of total backwardness: its buildings drab, peeling and covered in scaffolding; 40 year old trams and spluttering Trabant cars running on its streets; and its shops bereft of goods other than those that had started to come in from the West. Dresden, its historical jewel, had been ruined by communist kitsch as much as by Lord Harris's bombs, and outside the chemical factory town of Bittenfeld I saw a lake that looked as if it were used oil which would explode if you threw a match in it.

I have not met one East German who did not regard Bill Andersen's dream as a politically, economically and morally degenerate nightmare. Yet Mr Andersen remains a leading figure in the trade union movement, the *Herald* continues to print his articles and his views have not changed one iota. Council of Trade Unions president Ken Douglas has stopped making well-publicised visits to Moscow for health care but continues to write paeans to socialism, and Peter Harris of the CTU still calls for a return to a planned economy. For such people, opposition to the market economy is a religion or dogma that is not amenable to facts or reason.

Similarly, there are many in the leadership of the traditional churches who are ignorant of how markets work. A recent survey of Australian economics professors ranked the level of economic understanding of the churches in Australia as barely higher than "very ill-informed." There is no reason why Christian commitment should preclude intelligent comprehension of economic science, but I would judge the situation here to be at least as bad, particularly among the politicised clergy. Others show more understanding in private: one church leader who signed last year's social justice statement told me he supported the Employment Contracts Act and understood the argument that minimum wages are harmful. However, it is clearly not politically correct to express such views in social justice circles.

People tell me not to worry about the economic illiteracy of the so-called church leaders. They point out that the traditional churches are in decline and that those that are growing are more favourably disposed to market economics. However, it is sad to see the intellectual leadership of formerly respected institutions in such poor shape.

The amount of empty rhetoric that masquerades as serious economic commentary in some church circles is quite extraordinary. Continuing in the tradition of populists such as Sir Robert Muldoon, Cardinal Thomas Williams ingenuously proclaims that "the economy is about people", as if this were an argument against a competitive market economy. How could an economy be about anything else? Its only purpose is to serve people's needs - for goods and services, for jobs, for returns on their savings, and so forth.

The Reverend Richard Randerson wants emphasis to be given to the social deficit rather than the fiscal deficit, as though excessive government spending, taxing and borrowing have not been a prime cause of our social problems. He claims to abhor so-called "extremist" views, arguing for "balance" and believing that "the truth lies somewhere in the middle." This is, at best, intellectual turpitude. Presumably he would have us believe that the world is neither round nor flat; perhaps a "more balanced" view is that it is pear-shaped. Some people believe God exists. Others say there is no god. Does the truth lie somewhere in the middle?

It is still popular in church newspapers such as *The Tablet* to argue for some "middle" or "third" way between capitalism and socialism, between markets and plans. Look at Sweden, some people used to say. With unsustainable levels of government borrowing and debt and high unemployment, Sweden is now in massive economic difficulties. I was relieved that when someone commended the Swedish model at a church gathering I attended recently, the whole room burst out laughing.

Some of the clearest views on such muddled thinking come today from the countries of the former Eastern bloc. Prime Minister Vaclav Klaus of the Czech Republic has called the so-called third way "the fastest way to the third world." Mart Laar, Prime Minister of Estonia, has written:

> ... the most leftist of governments in Central and Eastern Europe are reshaping their economies in line with principles which, in a Western European context, seem very right-wing.
>
> For example, trade unions, along with their damage to free competition, are practically unknown in Eastern and Central Europe. Nor is there a costly social economic system: one which discourages people from searching for new jobs and helping themselves, and allows them passively to hang on. Grants and subsidies are gone. All this, together with low taxes, the radical reduction of the role of the state, massive privatisation and a very conservative financial

> policy - and it can be seen why Eastern European leaders are accused of Reaganomics or Thatcherism.

Prime Minister Laar added:

> *All* Europe needs to change: to forget state welfare and comfort and passivity, to enable individuals actively to shape their own futures; to dismantle barriers restricting free and fair competition, and to accept the risks inseparable from enterprise and freedom. Above all, to remember that wealth is propagated not by states and governments, but by free, talented and independent individuals.

During a visit to Britain earlier this year at the invitation of the British government, I had the pleasure of meeting Andrew Gamble of the politics department of the University of Sheffield. A former Marxist, he is nevertheless a thoughtful academic with influence in British Labour Party circles. His opening remarks were that the debate is no longer between capitalism and socialism; it is about which model of capitalism is best. He identified three: the Scandinavian model, the Anglo-American model and the more free-market Asian model. That strikes me as a more reasonable position, although there are large question marks over not just the Scandinavian model but many features of the Anglo-American model as well.

The 20th century is ending very differently from the way it started. It looked for many decades as if it were going to be the century of collectivism. Fabianism in Britain, communism in the Soviet Union, fascism in Italy and nazism in Germany - collectivist creeds all - looked like the wave of the future. Another variant was apartheid, described by historian Paul Johnson as:

> ... a system of social engineering, cooked up in the sociology department of Stellenbosch University, which has much more in common with Marxist-Leninism or indeed Nazism than anything from the West.

A little later Keynesian economics reigned supreme, with its vision of a wise government maintaining full employment by offsetting the deficiencies of the market place. Incomes polices followed, and then the welfare state, from its small beginnings or extensions in the 1930s to the American Great Society and Swedish versions of the 1960s and 1970s. By the last quarter of the century, all of these icons were no more - their tyranny defeated in bloody conflicts, their record of economic stagnation rejected - or, in the case of the welfare states, were subject to universal criticism as hopes of a more compassionate way of dealing with human misfortunes were buried under mounting evidence that government-provided welfare was the cause of many of them not the cure.

Some of the most forceful criticisms of the growth of the welfare state have come from Pope John Paul II in the encyclical *Centesimus Annus*. He refers to the "excesses and abuses" of what he calls the "social assistance state" which gives rise to several unintended evils, in particular:

> By intervening directly and depriving society of its responsibility, the social assistance state leads to a loss of human energies and an inordinate increase of public agencies, which are dominated more by bureaucratic ways of thinking than by concern for serving clients, and which are accompanied by an enormous increase in spending."

The Pope argues that needs are best met by people who are closest to them and commends a response "which is not simply material but which is capable of perceiving the deeper human need."

The collapse of these various forms of collectivism has come with extraordinary speed. The American economist Thomas Sowell made this point in a recent article. He wrote:

> Anyone who would have predicted the reversal of this [collectivist] trend, with privatisation being introduced by socialist and labour governments from France to New Zealand in the 1980s, much less the collapse of communism in Eastern Europe and the Balkans, and the dismemberment of the Soviet Union and Yugoslavia in the 1990s, would have been considered mad just a dozen years ago.

Sowell also notes that the kindred forms of collectivism - from fascism to communism - drain of any meaning the facile dichotomising of the political spectrum into left and right. Some of our most ideologically-inclined academics and journalists continue to describe orthodox market economics as "new right" policies. I read recently that the University of Peking, China's top academic institution, has eliminated Marxism from its programmes and it is a pity that our universities have not followed suit. However, it was pleasing that the editorial department of *The Press* recently agreed with a correspondent that labels like "new right" were entirely inappropriate and would be dropped by the newspaper, and we can only hope that this practice will spread.

New Zealand has followed the intellectual trajectory of the 20th century. An early 20th century visitor made the observation that New Zealand governments practised "socialism without doctrine." Rowan Callick recently noted in the *Australian Financial Review* that George Bernard Shaw in the 1930s described the country, with warm approval, as "communist". Callick added that it was a pioneering welfare state which reached twin zeniths of economically unsupportable cradle-to-grave care, first under the socialist Michael Savage, then the corporatist Sir Robert Muldoon. His article also made the point that New Zealand remains touchingly fascinated by the old political boundaries and that "Its media still nitpick between who is Right and who is Left (and thus right)."

New Zealand has now moved towards the market economics mainstream, though we still have a long way to go. In terms of rates of growth of production, investment, employment and inflation, we are currently around the best in the OECD, but below the overall performance of the leading Asian economies. Yet many New Zealanders still seem racked with guilt about our economic directions and success. Given our past intellectual traditions this is not surprising, but it is making it difficult for many people to come to terms with the nature of a healthy market economy.

The first problem arises with the very terms capitalism, capital and capitalist. I prefer to speak of market economics as a more easily grasped description, but the term capitalism deserves to be rehabilitated. In the lexicon of Marx, who invented it, it was of course a term of opprobrium. Essentially, you will recall, Marx held that the owners of capital had inexhaustible power to accumulate all wealth to themselves, oppress workers and drive their wages ultimately to starvation levels. Despite the fact that logic and history show this notion to be a complete fallacy, echoes of it are still heard in our labour market debate even today.

Returns on capital do not rise - real returns on stocks have averaged about 6 percent and returns on bonds under 2 percent over the long run. They do not show a growth trend. What rises is the stock of savings and investment, and with it wages as workers have more and better equipment to work with. Far from hitting starvation levels, wages have risen beyond Marx's wildest dreams. Capital is the workers' best friend. Even workers whose own productivity has risen little - say, waiters or hairdressers - are far better off than their earlier counterparts because capital formation has made economies more productive and competition in the labour market has bid up their wages.

Closely associated with capitalism in Marxist demonology is the notion of greed. Stripped of its emotive connotations, greed seems to refer to the desire of people to improve their incomes. Curiously, this phenomenon does not seem to be confined to the capitalist classes but can be found, for example, in the wage claims of members of the so-called 'caring' industries such as primary school teachers, nurses and social workers. Another irony is that in competitive markets the only way people in business can make more money is by meeting consumers' needs better. Thus the more 'greedy ' and 'rapacious' people in business are - to use the terminology of the chattering classes - the harder they have to work to serve consumers. Small businesses become big businesses because they meet consumers' needs very well. I have nothing against people making more money in this way. To me, a more reprehensible form of greed is that of people who wish to make more money by electing politicians who will take it from others on their behalf.

The Catholic theologian Michael Novak notes that:

> The cultural elite masks its will to power by calling the financial elite greedy. It diverts attention from its contempt for common people ... by trying to teach people to hate "the rich" - by which, of course, the glitterati do not mean the rich in the entertainment industry. They refer to those among the rich whose sweat produces goods and services, who imagine whole new industries and create real private sector jobs.

Novak has observed elsewhere that, on the whole, ordinary Americans do not envy even the very rich: they rather enjoy their antics, their divorces, their temporary splendour and their fall. Usually the rich do not keep on getting richer. The more typical pattern, as the saying goes, is "rags to riches and back again within three generations." There is enormous churning mobility, upwards and downwards, in market economies.

One of the more entrenched doctrines of our time is that capitalism is all about selfishness. What many people find dubious about such a system was memorably expressed by Adam Smith in his famous passage on the invisible hand. Those who participate in such systems, Smith said, promote the public interest most effectively by pursuing their own interest.

We have already seen that people in business who are concerned to make profits can only do so by discovering and serving the needs of others - their customers. Moreover, pursuing one's own interests is not the same as behaving selfishly. People who pursue their own interests are only behaving selfishly if their interests are selfish. Nor does the pursuit of self interest exclude altruism. People may give to others in need in the hope that someone will help them if they are in need in the future, or without any such hope at all.

It is also useful to consider the alternative to people pursuing their own self interest. What if they didn't? If people systematically did things which were damaging to their interests we would soon end up with a pretty disfunctional society. We all make mistakes, but we learn and correct them. Without the concern for self and family, the very survival of any species would be at risk.

Alternatively, consider what would happen if we tried to pursue other people's interests rather than our own. Done in a systematic way, this is what Hayek calls the "fatal conceit" of socialism: the idea that we know how to run other people's lives better than they do themselves. That road leads to paternalism at best and tyranny at worst. Adam Smith was an anti-utopian political thinker, deeply suspicious of what he called the "man of system" who thinks he can reform human nature or move people around like pieces of a chess board in the name of some grand design.

The economist Paul Heyne who is visiting New Zealand next month has an interesting discussion of paternalism. It concerns the 19th century British art critic John Ruskin who criticised economists even more than he criticised bad architecture and bad painting. "Employers," Ruskin said, "should treat employees the way they would treat their own sons." Adopting modern non-sexist language, we may call that attitude parentalism. Heyne asks:

> Does that strike you as a worthy ideal? ... I want you to think again. It is a *monstrous* ideal. ... Parentalism degrades its victims and corrupts its perpetrators. I do not want the Chancellor of my university to treat me like a child, not even like his own child; he is in reality not my father and should not behave toward me as if he were. Parentalism is appropriate at most in actual parents who know their children intimately, who love them as much as, if not more than, they love themselves, and who recognise that their children have a unique claim on their resources. In those cases parentalism is appropriate. When those conditions are not met, then parentalism is degrading and corrupting. Employers should treat their employees like human beings, of course, with decency and common courtesy. But beyond that they should treat them as people who have something of value to offer the firm for which they will therefore have to be paid. This is not only efficient; it is also less unfair than the parentalist alternative. It is more worthy of both the employer and the employee.

A variant of the criticism of Adam Smith's views on the relationship between self interest and the public interest is that he saw society as simply an arbitrary aggregate of individuals. People accuse market economics of promoting "rampant individualism." But Smith had no such concept. He believed that "in civilised society, he [man] stands at all times in need of the cooperation and assistance of great multitudes." Smith, the purported radical individualist, argued that humans are deeply social beings with a capacity for mutual understanding that he called "sympathy", as well as a natural motivation to care for others.

As is so often the case, the confusion arises not over the goals but over the means of achieving them. On an intimate scale, sympathy, solidarity, personal knowledge and information unite people and make for effective joint decision making. In small social units like families, we can and should directly pursue one another's welfare. But the mistake collectivists make is to transfer this successful model to the society at large with its infinitely more diverse and complex interests and needs. In this larger, impersonal society we can best cooperate with thousands, even millions of people living around the world, whom we usually do not even see, by harnessing the power of the market.

Seen in this light, the market is an extraordinary information system which enables us to coordinate our needs far better than we could by means of any central plan. By signalling through prices people's wants and the relative scarcity of resources to fulfil them, by promoting an efficient division of labour and by enabling everyone to gain through mutually beneficial trade, the market is the means of linking individuals into an effective social order.

The final misunderstanding of markets that I shall deal with is that they promote inequality of income. Under a market system, it is said, the rich grow richer and the poor poorer.

An initial difficulty with this claim is that, while there may be short-term fluctuations, it is factually wrong over the long run. Markets, in fact, are the most powerful equaliser of incomes. This is true whether one compares the incomes of different groups within a country or the experiences of different countries over time. Typically the rich have grown richer but the poor have grown richer faster. Open and competitive economies, such as the best performers in Asia, have a remarkably even income distribution. More interventionist economies usually end up with a less even income distribution. For example, "communist" China has greater inequality of income than Taiwan and South Korea, and statist Brazil has one of the world's most skewed income distributions.

There are deeper problems with the notion of equality of incomes. Equality in anything is not the norm. People do not have equal personal capacities, purposes and energies. How can incomes be equal if talents are not? I cannot jump as far as Carl Lewis, sing as well as Jose Carreras, act as cleverly as Bill Cosby or create software as successfully as Bill Gates. Should I regard our differences as unfair? Short of an absolute tyranny, how could such individual differences be equalised? And why would that be regarded as morally admirable?

I am more concerned about alleviating poverty than equalising incomes, though the market economy happens to do both. Nobody is needy in the market economy because of the fact that some people are rich. The riches of the rich are not the cause of the poverty of anybody. The poor are better served by maximising production than by trying to equalise distribution. People experiencing misfortune should be helped, if possible through their own efforts (savings and insurance), if not by families, neighbours and fellow citizens on a voluntary basis, and as a last resort by the state. But providing a safety net is not the same as equalising incomes. As Michael Prowse, writing in the *Financial Times*, put it earlier this year:

> The way to come to terms with economic inequality is to recognise that the market system is not something that governments either created or can manipulate with impunity. Markets are sets of unplanned spontaneous exchanges; nobody plans the inequality and nobody is responsible for it. Inequality is simply the price we pay for a general level of prosperity unimaginable under any other economic system.

Nothing in what I have said denies an important role for government in the functioning of a healthy economy and society. To work properly, markets need a proper legal and economic framework which can only be laid down by the state. Markets also have rough edges which are best smoothed. As Thomas Jefferson put it in his first inaugural address:

> ... with all these blessings what more is necessary to make us a happy and a prosperous people? Still one thing more, fellow-citizens - a wise and frugal government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labour the bread it has earned. This is the sum of good government, and this is necessary to close the circle of our felicities.

When governments over-reach themselves, they do harm. The main economic lesson of this century is that government failure is broader and more damaging in economic terms than market failure, and that markets correct mistakes sooner than the state. But the over-extended state has been even more damaging in moral terms. Novak quotes one German Social Democratic leader as saying "We paid too little attention to the individual and we forgot personal responsibility", and goes on to say:

> Everywhere the welfare state went, the family was undermined; out-of-wedlock births multiplied (the illegitimacy rate in Sweden is twice as high as in the United States), and public morality fell precipitously. Gunnar Myrdal, one of the architects of social democracy in Sweden, mournfully confessed shortly before his death that he had never thought the renowned personal morality of ordinary Swedes could be corrupted - such predictions he saw only as

> rightwing scare tactics - but it had, and it was his beloved social democracy that did it.

Last year a very bright Chinese graduate worked at the office of the Business Roundtable before she went overseas to do a PhD. She showed me a book by a Chinese historian who noticed that Chinese people were not interested in government affairs. In the words of some farmers:

> ... there is a king in Manchuria, but we can't remember his name. ... What does it matter? ... he lets farmers settle there and beyond taking 20 percent of the harvest, does not bother people.

Wen Li believed such attitudes towards government still prevailed in China. People didn't usually expect the government to look after them. In fact history had taught them to mistrust governments, which were usually oppressors of one form or another, and were happy if governments simply left them alone. In her view, China was in much less danger of becoming a welfare state than many Western countries. If she is right, we may be about to witness in China the greatest economic miracle the world has ever known.

In New Zealand, the market economy was in danger of extinction by the early 1980s. Fortunately it has been reconstructed, and we are now enjoying a remarkable economic turnaround. There is still much to be done, and there is still a long way to go to spread public understanding of its virtues. Hayek shrewdly addressed his famous book *The Road to Serfdom* to the collectivists in all political parties, and they are still with us today. We will know we have made progress when more of them have taken heed of the remarks of *The Economist* in a recent leader, 'The left's new start'. It said:

> The goals of defeating poverty, expanding economic opportunities for the less well-off, and improving the quality of public services will only in fact be achieved by people who can say the words "market" and "capitalism" without sneering.

This is a challenge some of our politicians and many of our social commentators still have to show they can meet.

THE DOMINION

KIWIS CAN FLY

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

13 JULY 1994

KIWIS CAN FLY

In an epitaph to what it called 'Muldoonery' written immediately after the 1984 election, *The Economist* said "New Zealanders have just voted for hard times."

By that it meant that the job of reconstructing an economy distorted by years of controls and subsidies, and debt-ridden through borrowing to sustain consumption and finance uneconomic 'Think Big' projects, would inevitably be a long and difficult one.

The Economic Summit of that year spelled out the essence of the problem:

> There is an unacceptable level of poverty. There are people in our community who have major difficulties with housing, health care, and meeting essential family needs. This ... has not been a short term problem but rather a feature of the New Zealand economy for the last 30 years ... . Poor growth has brought unemployment, falling living standards, a decline in social services and increasing social discontent.

The Summit consensus was that New Zealand needed to change course. Had we not done so, New Zealand's social problems - which are not just a product of the last 10 years but were clearly evident in 1984 - would have become immeasurably worse.

The reconstruction task - not unlike that facing East European governments in recent years - was to move from a state-dominated economy to a fully functioning market economy. The Summit urged the government to adopt a consistent, medium-term policy framework encompassing all the interrelated elements of the economy.

At the macro level, this involved stabilising an economy that had averaged a 13.9 percent annual inflation rate in the previous 10 years, and which was running budget and current account deficits in 1984 of 8.8 percent and 6 percent of GDP respectively. Persistence with a firm monetary policy (underpinned by the 1989 Reserve Bank Act) and ultimately a firm fiscal policy (now supported by the Fiscal Responsibility Act) have brought inflation down to around 1 percent and yielded a budget surplus this year.

At the micro level, the key decision was to open the economy to international competition with a programme to remove import quotas and tariffs, abolish exchange controls and float the currency. Other landmark reforms included deregulation of many domestic markets, tax reforms including the GST, the SOE/privatisation programme and public sector reforms and, belatedly, the deregulation of the labour market.

As expected, the transition was difficult. Matters were made worse by the fact that a well-conceived programme was marred in its execution. The failure to control government expenditure in the early years, and to raise revenue instead, put pressure on financial markets, the currency, and the private sector and created conditions which worsened the impact of the 1987 crash.

The other key failure was to adopt a tight monetary policy and free up other markets while leaving the labour market rigid. The high union-led wage increases of 1985/86 and the inability of firms to redeploy labour flexibly in response to competitive pressures were major factors in the steep rise in unemployment.

These problems were compounded by the loss of direction and confidence after 1987. Without the 'teabreak', the adjustment pain would have been less severe and the economy could have been in the position it is now in by the late 1980s. However, few reform programmes go "by the book." To have initiated a strong and sustainable recovery after seven years, when the 1991 fiscal and labour reforms finally completed a coherent framework, is a remarkable achievement.

In the ten years 1984-94, as the accompanying table shows, the economy recorded average annual real GDP growth of 1.6 percent despite massive restructuring, a slight increase on the 1.4 percent rate in 1974-84. The argument that New Zealand has experienced pain but no gain is invalid on this basis alone. More importantly, output growth is now running at an annual rate around three times higher than the average of the previous twenty years. There are no signs of pressures which would bring the expansion to a halt.

Only two years ago, many commentators were still maintaining that there was no light at the end of the tunnel. Now we are clearly out of the tunnel. The benefits are rapidly spreading with 70,000 new jobs being created since the Employment Contracts Act was passed and growth of a further 90,000 projected in the next three years. Households no longer have to cope with rising prices, mortgages are far more affordable and accessible, there is a much greater range of goods in the shops, services such as telecommunication, airline, taxi and postal services have improved out of all recognition, and we can now look forward to lower taxes and to higher wages as parts of the labour market tighten. These improvements are benefiting the whole community, not just better off groups as some commentators contend.

The outlook is bright if we persist with a policy framework which over the last ten years has been matched progressively by many other countries. There is still much work to be done to get unemployment down below currently projected levels and improve the delivery of health, education and other social services.

Although surveys indicate most people now believe New Zealand is on the right track, the jury is still out on the political sustainability of present policies. After years of familiarity with government protection and paternalism, the adaptation to an open market economy and less state welfare has been hard for many. Community understanding has not been helped by political failings in the difficult task of explaining the need for change. The rating agency Standard and Poors has deferred an upgrading of New Zealand's credit rating, citing uncertainty about the extent of the political consensus for reducing debt. The lesson of the last ten years is that kiwis can fly, but mismanagement and a return to former bad habits could easily see us become an endangered species again.

ECONOMIC GROWTH 1974-94

1974-1984	
Real GDP for year ended March 1974	89.3
Real GDP for year ended March 1984	102.7
Cumulative real GDP growth 1974-1984	15.00%
Annual average real GDP growth 1974-1984	1.41%
1984-1994	
Real GDP for year ended March 1984	102.7
Real GDP for year ended March 1994	119.9
Cumulative real GDP growth 1984-1994	16.75%
Annual average real GDP growth 1984-1994	1.56%

Index numbers rather than dollar amounts are shown. 1982/83 = 100.

THE NEW ZEALAND HERALD

DIRE PREDICTIONS OF UNIVERSITY ECONOMISTS PROVE TO BE TOTALLY WRONG

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

30 JUNE 1994

DIRE PREDICTIONS OF UNIVERSITY ECONOMISTS PROVE TO BE TOTALLY WRONG

Three years ago the 15 academics listed below wrote a letter to *The New Zealand Herald* attacking the government's economic strategy. All were members of the Economics Department of Auckland University. The academics wrote:

> We wish to state in the strongest possible terms our view that in the present state of the economy, and in the midst of an international recession, the deficit-cutting strategy is fatally flawed. It can only depress the economy further and because of this it will be to a considerable extent self-defeating .... .

Students at the university will soon be facing examinations. Three years to the month after the event, they may like to know whether their teachers deserve a pass mark for their predictions. And taxpayers may wish to judge just how good the 15 academics they support are at their jobs.

By way of background, it may be recalled that on taking office in late 1990 the National government was advised that a continuation of Palmer-Clark-Caygill policies would blow out the financial deficit from 3.3% of GDP in 1989/90 to almost 5% in 1991/92 and to 6.3% by 1993/94. The expenditure cuts, which the academics opposed, were directed at avoiding such a fiscal disaster.

The financial deficit was reduced to 2.3% by 1992/93 as a result of the government's decisions. A surplus equal to around 0.5% of GDP is expected to be recorded in 1993/94 (see Table 1) and increasing surpluses, boosted by a cyclical upturn, are now in prospect.

Was the economy further depressed as the academics predicted? Not at all. In fact economic activity stopped contracting shortly after the letter was written, remained pretty flat through to September 1992 and then began to grow strongly. The cumulative annual average rate of economic growth between the year to June 1992 and 1994 will be around 8% (see Table 2, column 2). The level of economic activity in June 1994 is likely to be almost 11% higher than when the letter was written (column 3).

Influences other than the deficit reduction contributed most to the low level of economic activity recorded in 1991 and 1992. External demand was particularly weak. Our terms of trade fell by 6.6% and 1.3% in the years to June 1991 and 1992 respectively.

Table 1
Financial Balance

Year Ended June	Financial Balance	Financial Balance to GDP
	$m	%
1991	-2,559	-3.5
1992	-2,449	-3.3
1993	-1,789	-2.3
1994	422	0.5

The government's estimate is shown for 1994.

Table 2
Rate of Economic Growth

Year Ended June	Annual Average Rate of Growth in Real GDP	Annual Rate of Growth in Real GDP
	%	%
1991	-1.2	-3.0
1992	0.4	3.3
1993	2.3	3.2
1994	5.1	3.8
1992-1994	8.0	10.7

The observation for 1994 includes the NZIER's forecast for the March and June quarters. The annual rate of growth is calculated using seasonally adjusted data.

New Zealand is now experiencing its most sustainable recovery for at least 20 years. 70,000 additional jobs have been created since June 1991, investment is growing strongly, the balance of payments is in a sound position and business and consumer confidence is high.

By the end of June, 12 quarters will have passed since the economy stopped contracting. This is almost twice as long as the average length of all cycles at least since 1965 (6.4 quarters). There are no signs of pressures that would bring the expansion to a halt.

There are unambiguous signs that economy is headed in the right direction. I would be the first to argue, however, that the job of reinvigorating the economy is unfinished, and that debt and government spending are still too high.

The policy of deficit reduction has not proved to be "fatally flawed" as the academics asserted. Rather the government has achieved its aim of balancing the budget within 3 years.

The academics' mistaken view reflected naive Keynesian thinking and failed to take into account the dampening effects on economic activity associated with high levels of debt and borrowing, high risk premia in interest rates, a crowding out of the private sector by the public sector, and continuing low levels of business and investor confidence.

By arguing that economic growth would correct the deficit, the academics did not appreciate that New Zealand had a structural deficit rather than a cyclical deficit. A structural deficit cannot be corrected by a cyclical upturn. (Similarly those who incorrectly argue that the emerging surplus should be spent are confusing a cyclical and a structural surplus.)

The alternative strategy followed by the government counteracted the negative effects of the deficit cut on demand and increased the economy's international competitiveness. The key elements were:

- greater consistency between monetary and fiscal policies. This was a direct result of the deficit and expenditure cuts. They took pressure off interest rates and the exchange rate;

- more competitive wage fixing procedures under the Employment Contracts Act; and

- increased productivity arising from microeconomic reforms.

Most of the policies which have driven the recovery were consistently opposed by the Auckland University critics of the post-1984 strategy, and others such as Professor Bryan Philpott of Victoria University. Besides resisting a fiscal correction, they also favoured a currency devaluation. This was to be implemented at the expense of the government's inflation target.

For their policy to be effective, a real and not just a nominal exchange rate adjustment was necessary. Past devaluations had failed because employees in sectors protected from international competition were soon compensated for the reduction in their real incomes. The resulting price pressures spread throughout the economy and quickly eroded the initial gains enjoyed by exporters and importers. The benefits of the 1984 devaluation, for example, were washed out within a couple of years.

The academics never adequately explained how a real depreciation would be achieved and subsequently sustained. They seldom acknowledged that devaluation is tantamount to a real wage cut. The abandonment of inflation targets would have undermined confidence in monetary policy, raised inflation expectations and started a new round of price increases. Under those conditions any real exchange rate decline and upturn in activity would have been short-lived.

Some of the critics of the strategy subsequently argued that monetary policy was eased in 1991 by the Reserve Bank to depreciate the currency as they had advocated, and that this explains subsequent growth. Their argument does not withstand scrutiny. Monetary conditions eased during 1991 in response to lower inflation and inflationary expectations. The Reserve Bank was able to further ease monetary policy in September 1991 without putting in jeopardy its inflation goal. This would not have been possible at a significantly earlier stage and without the complementary measures that the government had adopted. The overall policy package was vastly different from that advocated by the critics.

The thrust of New Zealand's economic strategy commands widespread support among authoritative agencies such as the IMF and the OECD, and internationally respected economists. It has, however, been persistently opposed by numerous New Zealand academics who peddle outdated ideas that are not supported by mainstream economists.

The minister of finance's 1991 observation that open letters advocating an U-turn in government economic policy had had a chequered history has proved to be prophetic. She referred to a similar dire warning that 364 British economists sent to Mrs Thatcher in 1981. Their letter coincided with the start of the longest expansion that the United Kingdom had experienced since the war. This lesson apparently escaped our academics.

A fail grade is the only mark that could be fairly awarded for their dismal effort.

Conrad Blyth (Professor)

Allan Catt (Professor)
Susan St John (Mrs - Senior Lecturer)
Keith Rankin (Mr - Lecturer)
Mr Robert Scollay (Mr - Lecturer)
Keith Jones (Dr - Senior Lecturer)
John Horsman (Mr - Senior Tutor)
Tony Endres (Dr - Senior Lecturer)

Steve Jones (Associate Professor & Head of Dept.)
Basil Sharp (Dr- Senior Lecturer)
Anjum Siddiqui (Dr - Lecturer)
Martin O'Connor (Mr - Lecturer)
Susan Laurenson (Mrs - SeniorTutor)
Gillis McLean (Mr - Senior Tutor)
Grant Fleming (Mr - Lecturer)

1994 YOUNG NATIONALS CONFERENCE

RESTORING FREEDOM TO CAMPUSES

ROGER KERR
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE

MT RUAPEHU
5 JUNE 1994

RESTORING FREEDOM TO CAMPUSES

I am giving this paper in a personal capacity. The New Zealand Business Roundtable has not even considered the issue of compulsory student unionism. Of course that hasn't prevented some parties making dark hints that we are behind moves to do away with it. Others may have the wit to realise that conspiracy theories involving the Business Roundtable and Michael Laws are a little hard to substantiate. However, I applaud Mr Laws' initiative, and I hope it might portend a new political environment in which attention is focused on the merits of arguments, not on who's on which side.

I am always very relaxed when I hear a conspiracy theory because it usually means your opponents haven't got many good arguments. There have been other events which have reinforced that suspicion. When the Laws bill was introduced, Jeremy Baker, president of the New Zealand University Students Association, was reported as claiming that student association membership was not compulsory:

> The Education Act, which makes provision for the payment of fees to students' associations, makes it clear that students who object on conscientious grounds can opt out of membership.[1]

To put it kindly, there is more to it than that. Frequently students have to raise their objections with their own association and have to pay the fee even if exemption is granted. There was a similar provision for conscientious objection in our old labour relations regime, but no one was brazen enough to claim we had voluntary unionism.

In any case, conscience shouldn't come into it. The reason why I don't belong to Greenpeace but do belong to the Maruia Society has nothing to do with conscience. I support the one (and benefit from its activities) and I don't support the other. If we value a free society, that should be the end of the story.

Another event which speaks volumes about the openness of students' associations to free inquiry and debate was the attempt earlier this year by Mr Baker and his polytechnic counterpart, Jason Hemopo, to ban Mr Laws from speaking on campuses. In tactics reminiscent of old-style trade union 'heavies', they instructed their member associations that:

> Students are quite able to debate the issue without the promoter of the bill putting his obviously biased point of view. The simplest way of dealing with this invitation is to decide that you have no need for him to 'explain' his bill.[2]

Something is clearly rotten in the citadel of freedom. But do not think for a moment that this is an isolated incident in today's institutions of higher education, especially universities. The extent to which politically correct attitudes and what Mr Laws called "fascist-like tendencies" have taken hold is genuinely alarming. The historian Paul Johnson has written:

> It is a myth that universities are nurseries of reason. They are hothouses for every kind of extremism, irrationality, intolerance and prejudice ... . The wonder is that so many people emerge from these dens still employable, though a significant minority, as we have learned to our cost, go forth well equipped for a lifetime of public mischief-making.

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[1] *The Press*, 15 March 1994.

[2] *Salient* 3, April 1994.

The debate over compulsory student unionism illustrates all these points.

Let us run through the arguments of the defenders of compulsion which have been rehearsed in recent months. Typically they go like this. Students' associations perform valuable functions. If compulsion were to be abolished, students would not join up and would bludge on their mates instead. Either the services would disappear or they would be provided in less satisfactory ways.

Students' associations may well perform valuable functions, but in no way does that constitute an argument for compulsory membership. The Consumers Institute, the Automobile Association, environmental organisations, chambers of commerce, trade unions in the new environment and professional societies all provide valuable services. People join because they value them. They are not compelled to do so. The fact that they are voluntary helps keep them accountable, responsive and efficient. If they fail to perform they lose members.

With all these organisations, non-members also benefit to some degree from their activities. That doesn't make them unviable or lead to calls for compulsory membership - even in the case of trade unions today.

Essentially students' associations provide two kinds of services. The first includes such things as cafeterias, newspapers, recreation centres, radio stations, campus clubs and societies and the like. All of these services can be charged for, and commonly are in whole or in part. They can be financed either by students directly paying for the use they make of them or by voluntary club subscriptions. They do not have to be financed through compulsory fees. There are off-campus alternatives to virtually all these services and some on-campus alternatives as well.

The second category of activities is representational services - on councils, academic boards or on behalf of individual students. Such services account for a minor part of the typical students' association budget. They may also be valuable, but they do not require compulsion. Employer organisations are represented on councils but membership of employer organisations is not compulsory. Voluntary trade unions exist to provide representational services, but employees and students also have alternatives available to them (friends, parents, lawyers, the media etc.) who can help deal with grievances. The Business Roundtable is engaged *only* in research, policy analysis and advocacy of national issues. It provides no enterprise-specific services that can be charged to individual member companies. To the extent that we are successful in promoting better policies, many others benefit. That hasn't prevented us attracting as members all but a handful of the chief executives of major companies on a totally voluntary basis.

Defenders of compulsory fees such as David Caygill and the Association of Polytechnics of New Zealand have argued that they are analogous to a tax. However, taxes should be levied essentially to pay for 'public goods' or to provide a welfare safety net. In these cases there may be no satisfactory private alternative. We have seen that students' associations generally provide services of a private not a 'public goods' type. They have none of the basic elements of the state: they defend no territory, apprehend no criminals, guarantee no contracts or property rights and are not welfare providers. It is inappropriate for governments to confer the power to tax on them or on tertiary institutions.

Students' associations have argued that under the Laws bill hardship grants would disappear. However, the hardship grants administered by some institutions do not meet sound criteria for a compulsory levy. The fee is imposed on all students at the same rate regardless of their ability to pay. One can imagine the outcry from the social justice industry if a national poll tax was imposed. Such student assistance, if it is needed, should come from general taxation, alumni donations or other revenue sources. This is a perfectly standard practice overseas.

Another objection to the case for voluntary membership, made by Les Holborow of Victoria University, is that "student associations are, and ought to be, more like professional associations than like unions."[3] There are hundreds of professional associations and all but a few have no compulsory requirements. Where the members of some of them, e.g. doctors and lawyers, are given the status of registered practitioners, this is essentially for consumer protection reasons. These reasons do not apply in the case of students' associations.

Professor Holborow has also argued that the adoption of Mr Laws' bill may mean the university can no longer provide an accommodation service, career advisory service and hardship fund. A response to this argument by a former student was as follows:

> My memory of university is being able to find my own flat through the newspaper or a private rental agency, finding my parent's advice more helpful and up-to-date than the careers advisory service, and an acquaintance buying a stereo with the money he conned out of the hardship fund. I suggest that the services provided by the university and student associations would operate more effectively if students had the right to choose whether or not they were worth paying for. [4]

In any event, the issue of compulsory student unionism and the issue of student levies for such things as accommodation and career advisory services are separate matters. They should not be confused in the debate.

On the basis of what the defenders of compulsion have so far said, I conclude that none of their arguments is valid. On the other hand, there are a number of positive reasons for preferring voluntary membership.

The first is that, like most monopolies, student association monopolies tend to be inefficient, unresponsive and arrogant. The quality of many of the services they provide is sub-standard and compares poorly with off-campus alternatives. Frequently they lose money. In 1991, when Mr Baker was student president at Victoria University, even the bar ran at a loss. That has to be quite some achievement if my knowledge of students is not seriously at fault. Students' associations are notorious for financial mismanagement. Earlier this year no fewer than three were under investigation by the police or the Serious Fraud Office. One association recently agreed to pay the fine of a student who threw paint bombs before being forced to reverse its decision. Stories such as these were rife in the days of compulsory trade unionism; they have become few and far between since union membership became voluntary.

A second endemic problem with the political and monopoly structure of students' associations is that by taking small amounts from many they can deliver large benefits to a few. As one author puts it:

> Some students, such as writers on campus newspapers, gain access to large assets and expensive items such as printing presses. Others, such as student politicians, can gain access to offices, stationary, telephones, photocopiers, word processors, cars etc.[5]

Two representatives of the Freedom on Campus Network stated earlier this year that the Canterbury University executive managed to run up a $28,073 telephone bill in

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[3] Radio New Zealand 'Campus', 14 April 1994.

[4] B Hofmann, *The Dominion*, 26 April 1994.

[5] Geoffrey Ryan, 'Student Unionism: Economic Necessity?', in *Compulsory Student Unions: Australia's Forgotten Closed Shop*, Australian Institute of Public Policy, 1987, p4.

1992, a "vast improvement" on 1991 when the bill was $42,711. They pointed out that in 1992 Lincoln spent only $1,800, Auckland $494 and Victoria $1526 on phone calls.[6]

Patronage is also granted to clubs and societies that lobby for subsidies and in return vote for student politicians willing to deliver them. The political process makes decisions differently to the marketplace. Politicians deal in votes. Minority groups who are well organised and can deliver support in elections gain at the expense of the unorganised majority. The beneficiaries are often better-off students who have the time and resources to lobby and to enjoy the facilities provided. Less well-off students, mature students and part-time students are among those who often derive little benefit from them.

The usual response by student politicians and university administrators to expressions of dissatisfaction with student association performance is to tell students to "get involved." But for most people the effort required in "getting involved" is quite disproportionate to the results. It entails cultivating allies, organising voters, trading favours, attending interminable meetings and taking part in the whole process of politics. It can mean abuse and intimidation. It is not surprising that there is always a low turnout at student elections - typically between 10 and 25 percent. This does not indicate 'apathy' in any derogatory sense but simply that students have a different set of priorities. Getting involved in student politics is not one of them. We should not assign to the political process - with all its weaknesses - decisions that can be better made in other ways.

A third problem with compulsion applies particularly to the representational and advocacy role of students' associations. While it is argued that under voluntary membership non-members would 'free ride' on these services, under compulsory membership many students are 'forced riders' on activities they do not support or wish to pay for. As one student (commenting on the Todd task force report) recently put it:

> The political views and values upheld by the students' associations are not my own and I (and others) resent that they have the right to force me to be associated and to fund their views purely because of my status of being a student.[7]

Many students favour university fees and voluntary student unionism but their representatives do not support views that conflict with their interests. In addition, students' associations have often supported extremist views and causes. Mr Baker has continued to argue that tertiary education should be "free" whereas even the student association representatives on the Todd task force were forced to accept the compelling arguments for fees, at least at present levels.[8] Another example, described as "nutty" and "xenophobic" by the *National Business Review* (which suggested the sooner compulsory membership is abolished the better), was the claim by NZUSA that the conclusion of the Uruguay Round would undermine New Zealanders' control of the education system.[9] Earlier this year Mr Baker criticised the long-overdue increase in entry standards from 4 D grades in Bursary to 3 Cs in a statement that *The Herald* exposed as sub-literate.[10]

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[6] *Canta* 17, March 1994.

[7] Sarah Borrell, *Otago Daily Times*, 23 May 1994.

[8] *The Evening Post*, 21 May 1994.

[9] *National Business Review*, 22 April 1994.

[10] 'A few misfires in this broadside', *The Herald*, 29 January 1994.

It is no response to criticisms of this sort to say that the answer lies in conducting referenda among students, for example on the issue of whether student association membership should be compulsory. Mr Laws has recently raised this possibility as an alternative to his bill. This would be an unjustifiable procedure. Would anyone seriously argue for a ballot of motorists to determine whether AA membership should be voluntary or compulsory? If 51 percent of students or some higher number voted in favour of compulsory membership, that would not justify compulsion for those who did not. Such provisions used to exist in our old industrial relations law. The government rightly abandoned them in favour of a straightforward rule of freedom of association and no political party has proposed returning to them.

A final reason why compulsory student membership is unjustified relates to the changing nature of higher education. The homogeneity of the student population is breaking down, and the 18-20 year old full-time undergraduate is no longer the norm. For many part-time, extra-mural and mature students, the students' association is an irrelevance. Campuses are becoming more diversified. In the case of Victoria, for example, students located at Vivian Street, Lambton Quay and Heretaunga may seldom get anywhere near the Student Union. The imposition of compulsory fees on such students is patently unfair.

What should replace conscription? The essential requirement is to make membership completely voluntary and to allow the establishment of rival students' associations. This will require associations to attract members by offering them services which they value sufficiently to make membership worthwhile. Allowing rival associations will promote competition for members which will create further incentives for performance. Even the possibility of a new association being established would be a spur to better performance. Individual councils should be free to determine what association they should have with student bodies.

Among the many benefits which I would see arising from voluntary membership is a much stronger focus on what really matters for students, namely the cost and quality of their education. Students' associations have often campaigned against higher fees, but they have taken far less interest in the efficiency of tertiary institutions and the quality and relevance of courses. The examples of wasteful spending recently highlighted by the minister of education, and the reviews of the Auckland University sociology department and the Victoria University law department which found major problems in them, are only the tip of the iceberg. Academics visiting New Zealand are often appalled at the low quality of some of the teaching and research in our universities. These are the issues that should preoccupy student representatives.

One of the reasons why students do not take an effective interest in the standards of teaching and research is that there is a symbiotic relationship between the current monopoly students' associations and tertiary education authorities. It is no surprise that vice-chancellors and members of councils have come out strongly against Mr Laws' bill. As one former student newspaper editor explains it:

> University councils are extremely conservative, if not reactionary, bodies. Like public monopolies, they seek "modest profits and a quiet and comfortable life" and aim to foster peace and stability in the affairs of the university - even at the expense of human rights. This means not upsetting vested interests like student unions which will create such an uproar should their compulsorily-extracted income be replaced by an income dependent on their actual appeal to students.[11]

One aspect of the symbiotic relationship is that councils can, to some extent, control and manipulate the representatives of monopoly students' associations and deflect

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[11] Stephen Kirchner, 'Implementing Voluntary Student Unionism,' *Compulsory Student Unions: Australia's Forgotten Closed Shop*, op. cit. p58.

criticism of their own performance. Thus university authorities have complained that in the absence of a statutory association they would not know which representative groups to recognise and deal with. This complaint is similar to that of former dinosaurs in employer ranks who wanted the government to legislate to ensure they only had to deal with one bargaining agent. The government rightly told them it was their job as managers to manage such relationships - which in practice they have got on and done.

What would happen to students' associations and tertiary institutions if membership were made voluntary? Some, like Victoria University Treasurer Bernard Galvin, have argued that neither could function without compulsion.[12] This is an extraordinarily bold claim. A contrary view, which I suspect is closer to the mark, is that "without student unions, students' *raison d'être* - gaining a university education - would be affected hardly at all" - it would make little difference to students' study and academic accomplishments.[13] In any event, no evidence that students' associations could not survive on a voluntary basis has been offered. Similar claims were made about the demise of trade unions if their monopoly privileges were removed, and they have been shown to be unfounded.

A further test is to examine evidence from New Zealand before association membership was made compulsory and from tertiary institutions where it is not required. At Canterbury and Otago universities, students' associations were set up on a voluntary basis in the 1890s and operated for many years, attracting a high proportion of students and providing many services, before compulsory fees were imposed. There are many examples of overseas institutions which do not operate with the kind of compulsory membership rules that apply in New Zealand.

There is no doubt that students' associations would change under voluntary membership. I would expect them to cut costs, sell or lease many of their trading operations to private enterprise, drop some services and introduce new ones. Certainly the prices of some services might go up if subsidies were withdrawn, but those that benefit from them would then be meeting the real cost - a fairer arrangement. Others might prefer to save the sizeable students' association fees that are now levied - in Auckland's case, for example, $139 a year for a full-time student or twice the average tuition fee increase proposed in the first year under Option A in the Todd task force report. Fees might well come down if overseas practice is any guide. For a larger range of services than most New Zealand students' associations provide, the voluntary students' association at Michigan State University, for example, charges a membership fee of only US$10 a year. However, while these changes and others might occur, there are no grounds for predicting the general demise of associations, still less the collapse of valued campus services. Provided there is a demand for things like cafeterias and gymnasiums, we can be sure that an entrepreneur will supply them.

Compulsory student unionism is a vestige of New Zealand's controlled and regulated past. It has been aptly described as the "politics of the sandpit." It is an affront to principles of liberty and is arguably in breach of international conventions on freedom of association. It creates waste and unfairness by forcing on many students arrangements they would not voluntarily accept and which only benefit the few.

Abolishing compulsion should be part of a process of badly-needed reform in the tertiary education sector. Other related priorities should be the reform of councils and of management and employment arrangements - issues which the minister of education has often talked about but on which action has been lacking.

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[12] *The Evening Post,* 29 March 1994.

[13] Geoffrey Ryan, op. cit. p4.

Peter Costello, the newly-elected deputy leader of the Liberal Party in Australia and himself a former student president, has written:

> Although universities jealously guard their independence, their rights to free enquiry, and their rights to free speech, it seems they are all too willing to compromise their students' rights to freedom of association. ... University administrators (including vice-chancellors) have been all too willing to play bag-men in this enterprise.[14]

The parliaments of Western Australia and Victoria have legislation before them at present to abolish compulsory student unionism. A version of voluntary unionism has recently been enacted in Britain. It is time to end this closed shop in New Zealand.

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[14] Peter Costello, *Compulsory Student Unions: Australia's Forgotten Closed Shop*, op. cit. p vii.

COMMENTARY BY
THE NEW ZEALAND BUSINESS ROUNDTABLE
ON A SPEECH BY
THE HONOURABLE WINSTON PETERS
LEADER OF THE NEW ZEALAND FIRST PARTY

MAY 1994

COMMENTARY ON A SPEECH BY THE HONOURABLE WINSTON PETERS LEADER OF THE NEW ZEALAND FIRST PARTY

1 Introduction

- You invited the New Zealand Business Roundtable (NZBR) to comment on your speech "Time for Some Economic Nationalism" which was delivered at a public meeting in Pukekohe on 17 May 1994.

- We have strongly supported the view that the ideas and policies of all political parties should be taken seriously. They are rarely subjected to adequate examination. Careful scrutiny is warranted in the interests of promoting better policies and informing voters. For these reasons, the NZBR welcomes your invitation to comment on the policies outlined in the speech.

2 Points of Agreement

- The NZBR agrees with a number of observations contained in the speech. The following points fall within this category:

  - New Zealand should review objectively its recent economic and social performance with a view to improving policies;

  - any such review should be carried out in an intellectually honest way;

  - policies implemented since 1984 have not been ideal. While supporting their general direction, the NZBR has also argued that government expenditure and the fiscal deficit have been reduced too slowly and that labour market reforms should have been implemented early in the reform programme. Moreover, a clear direction and momentum in policy were often lacking. This undermined business and investor confidence and meant that the costs of restructuring, particularly in terms of unemployment, were considerably higher than necessary;

  - unemployment remains a serious problem. This is widely accepted by New Zealanders. Differences arise, however, over the most effective solutions; and

  - government policy should be directed at maximising the welfare of all New Zealanders. There is a need for ongoing reforms to improve our present position.

3 Differences of Interpretation of Economic Data

- The NZBR questions New Zealand First's interpretations of some past and current economic data. While noting that economic performance in 1984 was "not great", 1984 has been adopted without further reservation as the benchmark year against which subsequent performance is assessed.

- An assessment of economic developments in 1984 should take into account the following points:

  - real GDP grew by 8.6 percent in the year to March 1985. The rate of growth was substantially higher than the average rate achieved over the previous 10 years. Growth was largely generated in 1984/85 by irresponsible fiscal and monetary policies aimed at the re-election of the Muldoon government. It was not sustainable as the foreign exchange crisis of 1984 confirmed;

  - the strong growth spurt and a wage freeze (which artificially lowered wages paid to New Zealand employees) temporarily suppressed further growth in unemployment. Make work jobs in the state sector, such as railways and the post office, also disguised the real level of unemployment;

  - the budget deficit peaked at the alarming level of 8.9 percent of GDP in 1983/84 before declining to 7.0 percent in 1984/85;

  - the current account of the balance of payments recorded a deficit of $1.9 billion or 4.8 percent of GDP in 1984/85; and

  - Think Big projects and some subsidies to farmers were initially funded outside the government's accounts. This helps to account for the growth in net public debt after 1984.

- The improvement in economic conditions since 1984 is better than suggested in the speech:

  - policies that will contribute to higher growth in the future have been implemented, although there is scope for further improvement. Most industries are more efficient and labour productivity has increased;

  - the economy began expanding in 1991 from a low base and is now recording solid growth (4.6 percent in the year to December 1993);

  - the present growth phase is almost twice as long as the average post-World War II expansion (11 versus 6.4 quarters). There are no signs of pressures which would bring it to a halt;

  - recent growth has taken place during a period of subdued international economic conditions. It has not been generated artificially but arises from increased competitiveness and higher productivity;

  - the budget deficit has been substantially reduced and a surplus is now in prospect. A surplus is necessary to achieve a sustainable reduction in net debt;

  - the current account deficit is small and falling;

  - employment is increasing faster than most forecasters predicted. In the year to March 1994, employment rose by 57,000 or 3.9 percent. On a seasonally adjusted basis, 75,000 additional jobs have been created since the upturn began. Employment is at the highest level recorded since March 1988, that is, before the downturn which followed the 1987 sharemarket crash;

- the rate of unemployment has declined by around 2 percentage points over the past 2 years to 9.1 percent; and

- business confidence is at its highest level for 20 years.

- A reduction in the rate of inflation is not the only indicator of social or economic improvement achieved since 1984 as the speech suggests. As noted above, significant improvements have been recorded in a number of key areas.

- More importantly, the real issue is what rates of growth, unemployment and inflation would have been recorded in the absence of the reforms that were implemented. New Zealand would have performed disastrously in these areas if policy settings had remained unchanged.

- No respected commentator has suggested that a reduction in inflation would solve all New Zealand's economic and social problems. The NZBR has consistently advocated a balanced set of economic policies incorporating mainstream economic advice.

4 Policy Prescriptions for the Future

Monetary Policy

- There is wide support in the economic literature and among reputable agencies, such as the World Bank and the OECD, for the proposition that monetary authorities should be charged with the sole objective of maintaining price stability. The countries with the best anti-inflation record over many years are those with central banks which enjoy a large measure of independence and focus on price stability. Germany, Japan, Switzerland and the United States are examples. For this reason, the NZBR supports the Reserve Bank Act.

- The Keynesian argument that higher unemployment over the medium to long term is an unavoidable cost of price stability was discredited in the 1970s. A contemporary view is that there is no tradeoff between inflation and employment, at least in the medium to long term. Put simply, inflation destroys jobs.

- The Reserve Bank is an inappropriate agency to be charged with achieving full employment just as the Department of Social Welfare is the wrong agency to promote international trade. This does not mean, however, that the goal of full employment is undesirable.

- If inflation were consistent with job creation, Brazil and Russia (with annual inflation recently running at 3,959 and 622 percent respectively) would be experiencing a severe labour shortage. Sadly the opposite is the case.

Interest Rates

- The adoption of sound, credible policies reduces long-term, market-determined interest rates, although the policy has to take effect by increasing short-term interest rates above those that were achieved by printing money. Because it takes time to establish the credibility of any moves towards more responsible policies, the reduction in long-term rates may take many years to be reflected in observed 5-10 year bond yields. New Zealand's longer-term bond yields are now well below Australia's, whereas for many years the opposite was the case.

- In contrast, irresponsible policies increase longer-term rates and bring the certainty that one day short-term rates will have to be increased when those policies prove to be unsustainable. We can hope to reduce long-term interest rates further by maintaining low inflation and progressively restoring our AAA credit rating.

Unemployment

- Unemployment is a problem in many Western countries and is higher in Australia than in New Zealand. Professional international commentators attribute the high levels of unemployment generally to structural changes and rigid labour markets, not monetary policy (or Asian competitors).

- New Zealand should aim to eliminate involuntary unemployment. Everyone who is willing to engage in productive work should be able to do so. The policies that will best advance the achievement of this goal are clear:

  - a stable economic policy environment;

  - flexible labour markets that enable people to price themselves into jobs and which encourage the acquisition of skills that are in demand;

  - a highly efficient education and training sector which enables citizens to obtain appropriate education and training; and

  - general economic policies that encourage enterprise and innovation, for example low government expenditure and taxes, and welfare support which does not unduly discourage employment.

Foreign Investment

- Inward foreign investment is viewed unfavourably in the speech. The NZBR has endorsed an open approach to foreign investment. Foreign investment is desirable because it:

  - supplements domestic savings and allows worthwhile investment projects to be undertaken thereby increasing output and incomes;

  - facilitates competition, transfer of technology and innovation. New products and ways of producing and distributing goods and services are introduced; and

  - permits appropriately structured firms to develop. There may be good grounds for some firms to expand across national borders. Foreign investment is necessary to achieve economies in such cases.

- Foreign investment permits New Zealanders to obtain a price for their assets which is determined in an international market place. In some cases, the price will be higher than otherwise because foreign investors value the asset more highly than domestic investors. New Zealand gains because the wealth of the seller is increased.

- New Zealand passed a degree of sovereignty to foreigners by running large deficits in the balance of payments and not spending the borrowed funds well. Such deficits aside, the proceeds from the sale of an asset to a foreigner represent a claim on the rest of the world which must typically be used to buy assets from other foreigners and/or reduce our debt to foreigners. Overseas debt is similar to foreign investment in that it leads to a claim on national output. These consequences arise because of the accounting relationships between the current and capital accounts of the balance of payments. It is the current account position, not changes in the ownership of particular assets, which determines 'sovereignty'.

- There are many reasons why New Zealanders are becoming more outward looking and are seeking to buy assets in overseas countries. If we do not allow this to occur by a process in which domestic assets are sold to foreigners, then we could force New Zealanders into even heavier borrowing from foreigners than exists at present, or into cutting domestic spending in order to increase savings through net exports.

- While inward foreign investment has increased since 1984, so has outward foreign investment. The overall net position is unknown.

- New Zealand First is not opposed to foreign investment in "new enterprises and new jobs". There are no valid grounds for distinguishing between new and existing enterprises, and the distinction would be difficult, if not impracticable, to implement. Is an extra job that arises when an existing firm expands any more desirable than one that occurs when a new firm is established?

Superannuation

- A compulsory superannuation scheme which it is believed would raise national savings, thereby reducing New Zealand's dependence on foreign capital, is proposed. The NZBR is sceptical that such a scheme would achieve that objective. Recent Australian experience shows that compulsory retirement income schemes mainly affect the form of savings rather than their magnitude. The high savings ratios of many Asian countries are not based on compulsory schemes. National savings have increased considerably in the past two years, including through managed funds.

- Another reason advanced for a compulsory superannuation scheme is to reduce dependence on New Zealand Superannuation. This option was closely examined but not supported by the Todd task force. Among the problems with forced savings schemes are biases in savings patterns, highly complex administration, inefficient capital allocation, likely pressures for financial market re-regulation and new uncertainties and disruption for the retirement savings industry. Restrictions on investments to New Zealand enterprises would increase the risks and/or lower the returns of superannuation funds.

- The key to retirement income provision is economic growth in a stable monetary environment which will allow more individuals to make appropriate savings plans. New Zealand First's tolerance of higher inflation would militate against retirement income security.

5 Concluding Comment

- A key issue is to identify economic policies that will best advance the welfare of all New Zealanders.

- There is substantial authoritative support for the view that governments can best contribute to economic prosperity and social progress by:

  - implementing sound monetary and fiscal policies aimed at maintaining low inflation and a predictable economic environment;

  - adopting open policies that permit international flows of goods, services and capital;

  - facilitating the efficient operation of markets; and

  - keeping government expenditure and taxes low.

  The NZBR's policy analysis is based on this approach.

- In many respects New Zealand First appears to be adopting an alternative course which runs the risk of undoing the progress made since 1984.

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