ALTERNATIVE TO REGULATION

A STUDY OF REFORM IN NEW ZEALAND

by Maurice P. McTigue

SINCE 1984 the small South Pacific country of New Zealand has experienced a period of dramatic reform. That country's economy was one of the most controlled and socialistic in the OECD. Today, two economic freedom indexes, one published by the Cato Institute and the other by the Heritage Foundation, rate New Zealand as the third and fourth most open and free economy respectively; in both cases it is ranked higher than the United States.

New Zealand's reforms are especially interesting for two reasons. First, ideology aside, the policies of both parties were almost indistinguishable. The left wing Labour Government had the courage to initiate the process of reform, and the right wing National Government subsequently completed the process. Second, reformers did not use government regulations to reestablish free markets; rather, they enforced rule of law and property rights and let competition in the market take care of the rest.

The three segments of deregulation examined in this article, the privatization of the communications industry, the creation of property rights to manage the state forests, and the deregulation of the labor market, serve as techniques that can be used by other countries.

THE PUSH TO REFORM

New Zealand's economy still relies on primary production from the land, the forests, and the fisheries. Industry frequently adds value to those products for export. Exports are crucial to New Zealand's economic success; more than 30 percent of GDP is exported. Growing international competition spurred much of the pressure for reform by increasing the adverse affects of statist policies that fostered inefficiency and strangled entrepreneurship.

Prior to reforms, New Zealand's government had taken a paternalistic approach to businesses. It had protected inefficient ones with trade barriers, subsidies, and other devices. Further, most policymakers viewed profit and the profit-motive as evils to be controlled. As a result, New Zealand was one of the most stagnant industrial economies and heading for Third World status.

Labour government reformers, elected in 1984, brought to office the attitude that policy should facilitate the delivery to consumers of the best quality goods and services at the lowest possible price. Providing the above objective was met, government would not concern itself with who owned the assets and provided the services.

New Zealand governments made two decisions that were at the heart of successful deregulation. First, all sectors of the economy were to be opened up to competition leaving no isolated pockets of industry protected. And second, competition, not the use of government regulations, was to be the single disciplinary force in the economy once the reforms were put into place. To that end, the Commerce Act, passed in 1986, put into statute the basic principles defining economic reform, including a strengthening of property rights. The Act defined in law that competition was to be the general principle governing economic activity. That principle makes it difficult for the government to regulate or reregulate the economy.

Using the rule of law as the means of encouraging competition would create certainty for entrepreneurs and would be less susceptible to pressure from special interest groups. That process has allowed New Zealand to achieve greater and faster efficiency gains than any other country that has deregulated its economy.

THE TELECOMMUNICATIONS INDUSTRY

In 1984 the entire telecommunications industry in New Zealand was owned and operated by the state as part of the post office. Performance was abysmal. Poor quality service was a major feature of all telecommunications services. While significant quantities of fibre optic cable had been laid, subscriber connections were recorded by hand. A new connection therefore required a manual search of all the files, and new subscribers were a low priority. No investment was made in computerization of record keeping. It usually took three months to have a new telephone connected in a major city.

The entire telecommunications system would overload nearly every business day between 9:30 AM and 3:00 PM. That meant an up to twenty minute wait every time a call was

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placed outside local calling areas. No price differentiation was made between high and low priority calls, between long distance and local calls, or between peak and off-peak hours.

Further, the equipment was always obsolete because the government always had higher spending priorities that were dictated by political concerns. The government had no incentive to meet consumer needs efficiently. The whole system was protected by a plethora of laws and regulations that prevented anyone from offering an alternative service. Consumers had no choices available to them. Telephones could only be purchased from one supplier, the government, and the choice was black or white, both with a round dial on the front. Faxes and other more advanced telecommunication equipment all had to be purchased from the telephone company. Because state-of-the-art equipment was usually not available to consumers or businesses, the country was losing its competitive edge.

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Breakdowns were frequent occurrences and repairs would often take a week. Even for minor problems, repairs were always done by three workers because that was what the union's agreement with the post office.

The inefficiency of telecommunications was a major disincentive to foreign investment and enterprise in New Zealand. For an island nation that relies heavily on international trade, instantaneous and reliable communications systems are crucial for competitiveness. Clearly there needed to be dramatic change, and it needed to happen quickly.

TELECOMMUNICATIONS REFORM

Enter the reforming Labour government in 1984. Despite an ideological disposition against the market, the new government knew it would have to dismantle huge state monopolies and open the country to competition least New Zealanders face accelerated economic decline.

The means for privatization telecommunication was set forth in a law that set the paradigm for reform in many sectors, the State Owned Enterprises Act of 1985. Telecom was first spun off from the Post Office as a separate entity. Second, it was given a private sector Board of Directors that was required to restructure Telecom's operation, and prepare the company for competition and then for full privatization. Throughout the whole process, they were required by law to maintain and improve profitability. Third, Telecom was required to make a profit. And fourth, Telecom's management was given authority normally enjoyed by private firms such as the freedom to dismiss workers and make investments.

After Telecom's reorganization, the government planned to sell off the company and remove all of its protections and privileges, making it subject to competition from any provider, foreign or domestic, for local, long distance, or cellular calling; equipment manufacturing and sales; or any other service. Also of note is what was missing from the new law. The Commerce Act, passed as Telecom was being reorganized, restricted the ability of the government to use regulation to continue, in effect, to manage or restrict the decisions of Telecom or of its competitors.

The new private sector managers for Telecom made excellence in the provision of telecommunication services their number one goal. The prospect of competition left them no choice. If they wanted to keep customers and, thus, revenues, they would have to deliver.

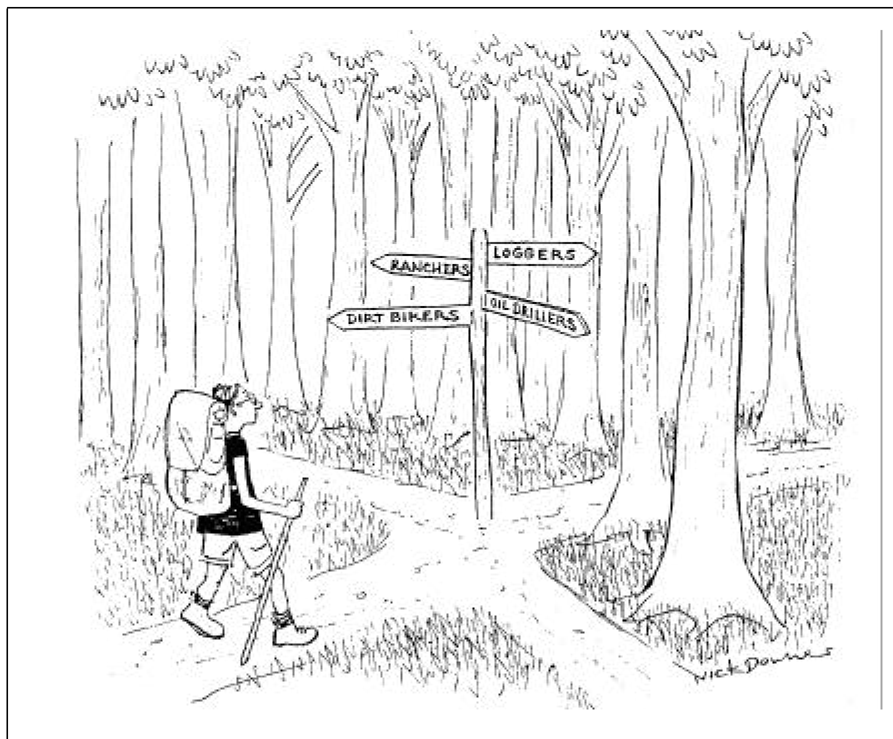
In 1989 the company was offered for sale. That privatization was different from others around the world at that time because 100 percent of Telecom was to be sold to the single highest bidder from anywhere in the world. Unlike other sell-offs of government assets, shares of stock were not sold to the public or to Telecom workers piecemeal. That was in part due to the considerable uncertainty about the actual value of the company. To avoid giving false information in a prospectus on the company, it was sold, essentially, "as is" with the responsibility of the buyer to beware. Further, selling the company to one buyer rather than piecemeal seemed best to ensure management's goal of providing the best possible service for customers at the lowest possible price.

One condition was attached to the sale of Telecom. The purchaser would be required not to diminish the size of the existing network thus avoiding the need for regulations to protect remote or small consumers, and also allowing the network owner to recover a fair and reasonable cost from competitors wanting to interconnect to the network. Another condition of sale was that the buyer honor existing contracts, for example, worker contracts.

Before privatization, the restructuring of the company saw many of the peripheral businesses spun off to the private sector, for example, provision of special equipment and retailing. This restructuring reduced the company's workforce by 66 percent, from around twenty-two thousand to ten thousand at the time of sale. After the sale, the workforce dropped to around seven thousand. Shedding peripheral businesses and the elimination of redundant, largely union mandated positions caused some of the layoffs. Because the managers and government reduced the workforce before the sale, taking the political hit up front, there was less resistance to the sale than might have otherwise occurred. Telecom NZ was sold in 1989 to a consortium of Bell, Ameritech, and others for $4.2 billion.

THE RESULTS

The combination of privatization and internationally open markets has brought dramatic increases in telecommunications services. The new owners have invested $4.7 billion for upgrades to the network, a sum greater than the purchase price of the company itself. As a result, the company guarantees to make new connections within twenty-four hours of a request, and if it does not, the company gives fifty dollars of free services to the customer. The company also guarantees to make



$4.7 billion upgrading the system. The company listed on the stock exchange in its first year of operation with a market value of $4.4 billion. Profitability in the year prior to sale was $70 million, profit in 1996 was $717 million, and on the stock exchange market capitalization has moved to $14 billion. Clearly, such reforms are a good deal for shareholders too.

The government believed that it would take new entrants about five years to gain about 4 percent market share of long-distance, cellular, on-line, and other nonlocal services. But the government was too conservative. The first competitor, Clear Corporation, appeared on the market in 1989, as soon as barriers were removed. The company gained a 20 percent share of the national market and a 23 percent share of international calls in the first five years. Now, Clear, Bell South, Sprint, Telestra, Netway, Cynet, and Centrex have joined Telecom NZ. Open entry allows competitors to make inroads into the market in spite of monopoly competition.

repairs within twenty-four hours of a complaint. Discounts for off-peak calls have cured the overload problems. This high level of load shifting has generated unprecedented levels of customer satisfaction. Business consumers get immediate access at peak times and residential consumers get much cheaper rates. The network system was recently judged by the OECD as having the highest technical quality in the industrialized world.

Critics of privatization without subsequent government regulation often fear that the large private firm, while not legally protected from competition, will still be able to increase prices without restraint. Surely, New Zealand's telecommunication privatization was a classic opportunity for just such corporate behavior. The evidence is quite the reverse. Over the first five years of operation the basket of business prices fell by 64 percent. The basket of residential prices fell by 54 percent. Telecommunication prices in New Zealand are now among the lowest in the OECD. The rapidly growing cellular market prices dropped by 33 percent. By anybody's measurement, consumers got a very good deal both in quality and in price.

Critics of privatization without regulations also fear that the former monopoly will use its market power to deny interconnection service to competitors or that it will charge prohibitive prices for interconnections. The terms of privatization required the new owner to provide interconnection but the terms were to be worked out by the parties. This process has been drawn-out and involved court actions. But now that terms in the first few cases have been established, future negotiations should go more smoothly.

The owners of the privatized Telecom also did well. They bought the company for $4.2 billion, and invested another

During the period of reorganization, Telecom's workforce shrank from twenty-two thousand to eleven thousand. And after it was sold, it shrank to to seven thousand. Yet competition with the former monopoly unleased enormous entrepreneurial energy, increasing total employment across the telecommunication market by over 50 percent, from twenty-three thousand to thirty-five thousand. The surge in overall employment more than compensated for the initial company layoffs.

THE STATE FORESTS

Starting in the 1970's, a debate raged in New Zealand concerning the state forests. Environmentalists and conservationists questioned the terms under which the government allowed the timber industry to harvest. But the timber industry was essential to the economy and restrictions on harvesting promised their own set of adverse effects. For a decade and a half the government tried to balance the interests of the two groups but to no avail. The problem was in the government's system of managing forests.

When a block of timber was judged ripe for harvest by the State Forest Service, that agency would take bids to determine who would cut the trees and reap the profit. The successful bidder had a clear cost incentive to cut the trees as quickly as possible in order to maximize profits. Delays meant lost revenues. Further, the successful bidder would pay the government based on how many cubic meters of timber it harvested, no matter the quality of the timber. Consequently, logging firms had strong incentive to clear cut, that is, chop down everything quickly, take only the highest value timber, and leave the rest to rot on the ground. That extraordinary waste of a precious natural

resource infuriated environmentalists and conservationists and did little to build a consensus on forest reform.

In addition, the timber was frequently going to low-value end uses. For example, eight hundred year-old trees were used to make toilet paper rather than furniture or even plywood. For higher valued uses, the companies would have had to inspect the timber to determine its best use and capital investments would be required to utilize every branch and twig. Companies seeking quick profits at low costs did not make such investments.

Of course, logging firms had no incentive to take an interest or investing the future of the forest because there was no certainty to whom the Ministry would award the next contract to harvest that parcel of land. Consequently, all restoration work fell on the shoulders of the State Forest Service. In most cases, the cost of such restoration far exceeded the revenues from the fees charged for harvesting. Politically, the existing regime created insurmountable problems. Banning the harvest of timber would harm powerful commercial interests and the economy as a whole. But the existing system threatened to deplete the timber supply with diminishing commercial returns.

EIGHT HUNDRED YEAR-OLD TREES WERE USED TO MAKE TOILET PAPER RATHER THAN FURNITURE OR EVEN PLYWOOD.

LEASING THE FOREST

In 1987 the government decided that a new policy approach was necessary. First, ancient forests were declared special conservation forests. Some of these special conservation forests were locked up in perpetuity as National Parks never to be harvested. Any harvesting from the others would only be permitted on a sustainable yield basis. Sustainable yield was defined as the removal of only those trees that had reached full maturity and the protection of the forest's ecosystem from processes like the clear felling mentioned above. Given the extremely long life span of those trees–between five hundred years and two thousand years–this policy meant that rather than cutting entire sections of trees, trees could only be harvested on an individual basis.

In New Zealand's case, it was relatively easy to distinguish the old indigenous forests from the new exotic forests that had been planted during the last one hundred years. By separating the two types of forests, the government was able to satisfy the public concern over conservation and simultaneously provide much greater security and certainty for the timber industry regarding its continued access to the forests.

The second issue was how to manage the conservation forests, previously the charge of the State Forest Service. A new ministry called the Department of Conservation was established. It was given responsibility for the management of the conservation forests and for ensuring that conservation and environmental values were enhanced. Further, wide public acceptance of the need to conserve old-growth forests allowed the new department to be funded out of general government revenues upon a vote by Parliament. That policy removed any potential conflict of interest with forestry companies seeking to cut down more trees and government agencies seeking to increase revenues by allowing them to do so.

The third issue to be addressed was how to manage the forests that were open to timber harvesting. The new policy needed to align the interests of the timber industry more closely with the interests of conservationists and environmentalist but still make economic sense. That goal could only be achieved if timber companies had a long-term interest in caring for the forests.

Under the new policy, over a period of about five years, the existing crop of exotic trees was offered on the market to the highest bidder from anywhere in the world. The government offered different parcels for sale, with the proviso that buyers honor all existing contracts. Further, the companies were required to replant a tree for each tree they cut and they could not change the use of the land. But unlike the old system, under the new regime, timber companies could be on the current standing crop of trees plus the next two generations of trees. Encompassing a time period of about seventy years, that arrangement in effect creates a quasi-property right for the timber company.

The arrangement gives the rights owner a long-term interest in improving the size and quality of the forests. His incentive is magnified by the fact that, unlike the old system, under the new regime the government would not spend public funds for restoration and upkeep of harvestable forests. Clearly, if the harvesters have an interest in the current generation of trees plus two future crops, then they have incentive to see that the land is replanted as quickly and as effectively as possible after the harvest. They also have an interest in seeing that the next crop of trees is subject to the best quality silviculture so that the resulting crop will be more valuable.

Another concern of conservationists and the general public was how to protect animal habitats, prevent soil erosion, allow public access, and preserve visual and recreational values without heavy handed regulation. The chosen way of resolving that issue was to write into the sale and purchase agreement a requirement that all of those values be preserved. The new owner of the forests was obligated by the conditions under contract law. Consequently, there was no requirement for any administrative law or regulation. Compliance was secured through contract enforcement and the use of the court, if such means should become necessary. The government, one of two parties to the contract, had standing in court. The contract approach also avoids nuisance suits by special interest groups that might seek to achieve in court what they could not achieve in legislation.

HARVEST OF BENEFITS

How did the policy work in practice? Purchasers came from all around the world, with about 55 percent of the forests going to overseas interests and about 45 percent to New

Zealand interests. Upon purchasing the forests, every new owner made a major new investment in further processing the raw timber into a higher end value product, in most cases valued at more than the purchase price. Those expenditures were not required by the purchase contract but new crop owners found such expenditures to be in their interest. That contrasts with failed past government attempts to encourage such investments by granting tax-free holidays, giving special land concessions, granting relief from regulations, and even granting interest-free loans. But with the certainty that they had seventy years to reap the profits of their efforts, companies were prepared to make the long-term investment necessary to significantly lift the value of production from the forests.

The net result was that, within a period of about four years, the value of timber harvested from those forests grew about 400 percent. The number of jobs in the forestry industry and in wood processing increased by 40 percent. An additional advantage of the new regime was that most of the new investment occurred in small, remote communities that had previously been considered economically disadvantaged.

When first proposed, sale of the forests was very unpopular. Public polling showed about 94 percent opposition. After the policy was put in place, people began to see additional investment, new jobs, and the better utilization of the timber from the forests; approval climbed to 60 percent.

New Zealand forest policy has been a success. Separating conservation forests from harvest forests helped defuse the debate between conservationists and timber companies. And using well-drawn, legally enforceable contracts rather than regulation as the means of holding the harvesting companies accountable for the quality and consequences of their activity, while at the same time creating a very significant increase in economic activity, has ensured the long term survival of this policy.

DEREGULATING LABOR MARKETS

In 1990 the newly elected conservative National Government of New Zealand embarked upon arguably the most dramatic reform of the whole reform process: fully deregulating the labor market. At that time the New Zealand labor market was extremely rigid and overshadowed by compulsory unionism.

Compulsory unionism was based on a concept called the "specified preference clause" that was mandated in all collective employment documents. Specified preference meant that if a union member asked an employer for the job of a nonunion member, the nonunion member had the choice of joining the union or giving up his job to the union member. New Zealand's labor markets were notorious for the large number of extremely disruptive industrial disputes, normally involving large-scale strikes in key industries. Such disruptions were destroying jobs in New Zealand's labor market by destroying New Zealand's market opportunities around the world.

Another anticompetitive feature of the labor market was the extreme rigidity of labor law and the process of negotiation. Normally, a union representing all workers in a particular discipline, for example, all of the country's electricians, would negotiate with an advocate who represented and spoke for all employers in that discipline. When an agreement was negotiated, it legally bound all employers and all employees.

Often the agreement not only specified rates of pay and entitlements, it specified how and when the work would be done, and other conditions that slowed work and added costs. For example, firms unloading ships were required to use three gangs of eight men each. But only two of three gangs were allowed to work at any given time. Further, only six of eight men in a gang were permitted to be working at any given time. Thus at any given time, twelve men would work while twelve remained idle. Clearly, in a modern world economy, continuation of that situation was impossible.

To restore flexibility and balance to the labor market, the government used a mechanism that defines a free economy, the right of contract. In the Employment Contract Act of 1990 the government established that all agreements between employers and employees would be in the form of a contract, enforceable in a court of law if necessary. The government also decided that there were to be only two parties in that contract, the employer and the employee. There was to be no role for government

beyond the courts. Further, union and employer organizations lost their formerly guaranteed right to participate in the contract negotiation process. All rights in the contract were reserved exclusively to the employer and the employee.

The law allowed for three types of contract: a written contract, the most secure form of agreement; a verbal contract, less secure but still readily enforceable; and an implied contract, the least secure form of agreement. An implied contract is established when there has been no actual negotiation between the employer and the employee. In that circumstance, the courts decide that the contract is what the employee reasonably thought the agreement was. Of course, an implied contract creates considerable uncertainty for employers, giving them a strong incentive to be very clear and diligent in arranging more secure forms of contract.

UPON PURCHASING THE FORESTS, EVERY NEW OWNER MADE A MAJOR NEW INVESTMENT IN IT.

The new law did mandate that certain basic conditions be included in every contract, implicitly if not explicitly. Workers were entitled to days off for all statutory holidays, paid annual leave, equal pay for equal work, maternity leave, sick leave, and a minimum wage.

The law also allows every employer and employee to choose his own negotiator, which could be a union. The other party can not refuse to negotiate with the chosen negotiator of the employer or the employee. The law also invokes a very strong nondiscrimination provision. Nobody can take legal or professional action against somebody for belonging to a union or not belonging to a union. No employer can refuse a person job because he is a member of a union and no union member can refuse to work alongside a nonunion member. In addition, since this arrangement is a formal contract governed by contract law, it is no longer lawful to strike over an issue that is not included in the contract. That major simplification of what was previously very complex legislation cut some ninety statutes and thousands of pages of law and regulations to 130 pages.

A LAW THAT WORKS

What has been the impact of those extraordinary changes to the labor market? First, the number of days lost through industrial stock stoppage were cut in half from over two hundred in the period from November 1989 to May 1991 to less than one hundred in the period from April 1991 to November 1992. Achieving an acceptable reduction in strikes was an essential test of the success of the legislation.

Second, the new labor law made unions much more accountable to their membership since workers were no longer compelled to belong to any union. Members stay with their union by choice, and that choice reflects whether they consider the services they receive from the union worth the union dues they pay. Thus different workers in the same enterprise might belong to different unions. Workers can choose whichever union they think will most effectively represent their interests. That whole process has brought higher accountability, which has meant that union performance and interest in members' issues has improved dramatically.

Another result of the new law is that the labor market responds more quickly to the changing value of skills and their price in the marketplace. Price signals now attract workers with certain skills to sectors where there are shortages.

New Zealand's success in the world market in the twenty-first century is going to be highly dependent on the technological skills of its workforce. And those skill levels can be dramatically improved if the rewards from the labor market go to those who are most diligent in continually improving their skills. In New Zealand, an additional benefit of the new labor law has been that, in wage negotiations, employers can offer an opportunity for employees to increase their skills through employer-funded training. A large number of employees have taken advantage of such training options, even preferring it to an increase in salary. Employers see the potential of gaining an advantage by investing in the development of skills inside their existing workforce, therefore avoiding higher training and education prices in the future. And employees have realized that upgrading their skills now will offer greater opportunities for higher wages and job security for the future.

Gone are the strict guidelines determining that one job must be done by a longshoreman and another by a ship's crew member, one by a carpenter and another by a laborer. A typical employment contract now states that the employee will do any job he is asked to do, providing it is safe for him to do so and he has been trained to do the job competently.

Eighteen months after the implementation of the changes, a Heyleen employee survey of 256,000 workers–20 percent of employment contracts–showed that the acceptability of the new labor market terms and conditions of employment has been extremely good. While 85 percent of the populace originally opposed the new labor law, 73 percent of employees are either "very satisfied" or "satisfied" with their working conditions and terms of employment. One reason for the turnaround is that the workers themselves have more direct communication with their employers and thus have a more favorable attitude towards the enterprises that pay them. As important, many workers have been able to negotiate more flexible working arrangements, such as starting and stopping times. Two-earner families with children especially welcome such flexibility.

The workers have fared well in terms of real purchasing power. Total average weekly earnings have risen from around $560 in 1990, the year the new labor law was passed, to around $615 in 1995. No doubt the rise in earning was a result not simply of the new labor law but of the other reforms made in other sectors over the past decade. It points to the wisdom of the overall market approach of New Zealand's reforms.

SUMMARY

For each of the major deregulations in three very different seg-

ments of the economy, interest groups were at odds and New Zealand's economic future was on the line. Rather than devise a compromise that might satisfy none of the groups involved and simply mitigate a present crisis by making a future one more likely, governments looked to solutions that were much more market oriented and required much less government oversight or regulation than has been attempted in other countries. New Zealand's economy thus is strong and growing. The lesson for other countries is clear: markets rather than government regulations are the paths to prosperity.

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