PROMOTING ECONOMIC FREEDOM: WHAT HAVE WE LEARNED?

THE NEW ZEALAND EXPERIENCE

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J.R.R.Tolkien's fantasy classic *The Lord of the Rings* has just seen the New Zealand film director, Peter Jackson, make Hollywood history with a record 11 Oscars awarded in recognition of his epic work producing the acclaimed trilogy of films. The global triumph of the New Zealand film team was the culmination of a decade of inspired work.

New Zealand has achieved equal global acclaim for the market reforms it embarked upon two decades ago. The Cato Institute refers to New Zealand as one of globalization's glittering success stories. The World Bank's report 'Doing Business 2004' stars NZ as the world's least regulated country, and one of the easiest places to start a new business. The OECD's survey of the NZ economy published in late 2003, describes NZ as one of the faster growing economies within the OECD during the past decade.

> "From 1992 to 2002 it grew at an annual average rate of 3.6 per cent, and has maintained a robust pace of expansion during the more recent period of global downturn. This represents a marked improvement n the economic performance of the preceding two decades, during which per-capita income levels in NZ declined relative to the OECD average. Underpinning this improved performance has been the programme of reforms that began almost 20 years ago."

This paper is designed to explain

- Why NZ undertook such a fundamental liberalization of the economy: this will involve an analysis of the climate for reform.
- What we did: this will involve an identification of the characteristics and coherence of the reform programme.
- How we did it: this will involve a discussion of the politics of reform.

The paper will finish by drawing some conclusions on what fellow reformers can learn from the process of undertaking successful economic transformation.

Why Reform

People around the world typically aspire to a universal set of ambitions:

- they want to enjoy a rising standard of living and access to jobs;

- they want to live in a country that confers on them the opportunity to foot it in the highly competitive world dominated by the forces of globalisation and technology;
- they want access to decent health, housing and social services;
- they want to live in a community that is safe;
- they want to know that their private property and political rights will be respected;
- they want to enjoy an environment that is cared for;
- they want to know that they will be secure in their old age;

In short they want to experience the qualities of good governance and good policy.

Each country has a different starting point, different cultures and different constraints. The points of difference are not a barrier to realising the universal ambitions documented above. The differences don't change the design of the policies necessary to get there; they simply dictate the emphasis and the execution.

Policy Design: The Universal Characteristics

The characteristics of the policy settings most consistent with achieving the stated ambitions are well known.

1. Monetary policy

Credibility hinges on operational independence for the central bank, a track record of successful inflation fighting, and a transparent, accountable and uncompromised commitment to the cause of price stability

2. Fiscal policy

Demonstrating fiscal responsibility requires the formulation of a credible and long-term fiscal strategy, the publication of explicit targets for prudent fiscal policy, the exercise of expenditure discipline, the disclosure of proper financial accounts and openness in the conduct of fiscal policy at all levels.

3. Labour market flexibility

Full employment is only achievable if first and foremost, people are free to work. Bringing down the barriers to jobs requires ridding the labour market of many extensive and often long-standing rigidities.

4. Open and competitive markets

While high and distortionary taxes are known impediments to performance, just as damaging are high levels of protection, and heavy regulatory burdens. Comprehensive deregulation of markets needs to be conducted on the basis that a level playing field will be created, and competitiveness assured by sound anti-monopoly policies. Tariffs should be recognized as a tax on exports, and a timetable should be developed to achieve, first, low and uniform tariffs, followed by a programme to reduce levels to zero.

5. Taxation

All good tax policy starts first by addressing the two key public expenditure issues; lowering the quantity of public spending and lifting its quality. Then the tax system should be designed in a way that is least distorting of business decisions and most productive of growth. That argues for a broad-base, low-rate tax regime.

6. Education

It is well recognized now that a nation's wealth creation capacity depends much more on the level of it's intellectual capital, than it does on either its physical or financial capital. The performance of the education system is vital to both economic and social performance. Education systems in most countries are state owned and run monopolies. They are liable to suffer from the same defects as any other monopoly – poor incentives for performance, lack of accountability to consumers, wastefulness in the use of resources. There are twin requirements for a modern education system; universal access and world class performance.

Reforms to best advance those objectives will involve the promotion of supply-side competition and the availability of choice on the demand side.

7. Health

In a field of constant tension between the supply of ever expanding and expensive remedies and the never ending growth in demand, the priority is to both maximise the efficient use of health resources and to maximise the choice and the responsibility of the user of health services. That argues for integrated health care, innovation and competition on the supply side, and funder choice on the demand side. The funding will typically be a mix of state funds, insurance money and private funds.

8. Housing and Social Services

Decent housing and social services are key ingredients of a decent society. The role of the State should concentrate on funding *access* to these facilities and services rather than providing them through government owned, run and funded regimes. The decision to fund access should be through an individually conferred entitlement, rather than by state monopoly provision.

9. Law & Order

An independent judiciary, free from corruption or state dictate is fundamental to the integrity of the legal system. Equally important is the timely administration of justice which calls for the efficient conduct of courts. Safety in society is only achieved if:

a. criminals know there is a high likelihood of being caught
b. the criminal code is well designed and adhered to
c. the corrections system is based on “tough love”

Increasingly a zero tolerance [or broken windows] policy [face the consequences of the first offence] is proving to be successful in demonstrating a serious intent to nip crime in the bud.

10. Security in retirement

Pay-as-you-go taxpayer funded retirement income regimes are now known to be unsustainable with an aging population. Increasingly the "three pillars" policy is being adopted involving:

- an insurance type pillar – a private sector retirement scheme
- a privately funded pillar where the private savings supplement a retirement scheme
- a state funded pillar to provide a social safety net for those who need it [the public redistribution pillar]

11. State Reform

State reform has involved twin tasks:

a. **Downsizing** the State, determining what the State should not properly do, leading to a programme of deregulation and privatisation.

b. **Modernising** the State; where the State has a core role ensuring that its responsibilities are discharged in the most effective and efficient manner.

This essentially involves moving to a performance management system where:

- Public servants are hired as professionals on performance contracts and for fixed terms;
- Public finances are managed on a proper balance sheet basis;
- Results based budgeting is adopted.

The New Zealand Experience: The Situation Prior to Reform

By 1984, New Zealand was without question the worst performing economy in the OECD. Our poor performance had been especially apparent over the ten years since the first oil shock in the mid-seventies. But in reality New Zealand's poor relative performance had been apparent for much longer. Productivity growth had been slower in New Zealand than in most other OECD countries ever since the World War II. Over the quarter century to 1984,

New Zealand had the lowest rate of productivity growth of any country in the OECD. Over the same period, New Zealand had the lowest growth rate of output per head, and the lowest growth rate of exports. We had also achieved the highest rate of debt build-up, in both government and external debt, and by 1984 were running the biggest current account deficit of any country in the OECD. Inflation in New Zealand had also been higher, on average, than inflation elsewhere in the OECD.

From having the fifth highest living standard in the OECD in the early 1950's, New Zealand by 1984 had slipped to 25th place. Even unemployment - long the favourite indicator of those who argued that the New Zealand economy "worked" - had started in the mid-seventies to trend upwards from its historically very low level.

The most fundamental causes of New Zealand's failure were micro-economic. New Zealand was an economy that used resources very poorly. We were internationally competitive only in a limited range of products, most of which were bulk export commodities. The remainder of the economy was very inefficient by international standards - an inefficiency that stemmed from misconceived policies of regulation and protection. In no other OECD country were market forces allowed such limited scope, and economic decisions so distorted by government intervention.

One of the worst examples of interventionist economic policies was New Zealand's industrial relations system. This system involved occupation-based national awards covering wages and conditions. Each award was negotiated centrally, and constituted minimum conditions binding on all workers of that occupation throughout the country. There was hardly any ability for individual employers or workers to opt out of the conditions struck in the national award. Along with Australia, New Zealand had perhaps the most inflexible labour market regime in the western world at that time.

In the late thirties and forties other policies were put in place to turn New Zealand into the most insulated economy in the OECD. Exchange controls were introduced. Very high tariff levels were combined with a system of import licensing for manufactured goods. The object of the policy was to build up the New Zealand manufacturing sector behind a protective wall. But the result was predictable: with a guaranteed home market, the incentive on New Zealand manufacturers was to be inward-looking and to avoid risk-taking. For most of the post-war years, the manufacturing sector was characterised by limited research and development, poor capital stock, inflexible work practices, and overmanning. Manufacturers attempting to export faced a high domestic cost structure, the product both of high import protection and a raft of regulatory burdens on the domestic economy.

The government itself had also become involved as owner and operator in a wide range of business activities. Government trading organizations were inefficient, often grossly so, and suffered mixed or unclear objectives. Some were effectively employers of last resort. Government businesses thus formed a substantial component of the protected sector.

During these years New Zealand badly lagged other countries in investment in post-school education and training. The implicit signal to young New Zealanders was that skill acquisition was not greatly rewarded. Wage differentials were narrow, with little premium for skill. Unskilled jobs were freely available. Also discouraging human capital development was an increasingly generous welfare state, which reduced the incentive on New Zealanders to provide for themselves through their own efforts. As time went on, escalating marginal rates of personal income tax, and an overall tax burden disproportionately falling on direct rather than indirect tax, further discouraged work effort and the investment in skills.

From the 1960's onwards New Zealand also saw increasingly poor macro-economic management. The government was often running significant fiscal deficits, adding to a savings-investment imbalance, which was reflected in the current account. Monetary policy

was becoming increasingly expansionary. In the mid-seventies the New Zealand economy was hit by the two shocks that accelerated its relative decline - the first oil shock and the entry of Britain into the European Economic Community (as it was then called), which substantially curtailed New Zealand's export markets. The actions taken by successive governments were reactive and ad hoc. A variety of new export subsidies were devised for both manufacturers and farmers. Some progress was made in developing new export markets. However, subsidies to exporters put considerable strain on government finances, exacerbating the large fiscal deficits of the late seventies and early eighties, and the rapid build-up of debt.

In 1982 the focus of macro-economic policy was switched to inflation, with the announcement of a comprehensive freeze on wages and prices. By 1984 - an election year - both fiscal and monetary policy had turned expansionary. The calling of a snap election for 14 July 1984 led to a drain on New Zealand's foreign exchange reserves. The election was won decisively by the Labour opposition. When the foreign exchange market opened straight after the election, the drain on New Zealand's foreign exchange reserves turned into a full-scale run on the dollar.

Thus the new government inherited a foreign exchange crisis, a very badly performing economy, and a set of economic policies of singular ineptitude.

Like many other countries, New Zealand for too long a period engaged in a studious refusal to reform. Instead of facing up to the structural impediments to better performance, New Zealand practiced the politics of postponement.

Doing nothing only served to increase our vulnerability. Crisis was ultimately the catalyst for change.

It is said that there are two things that can trigger political change; the first is opinion and the second is events.

For New Zealand, while the events demanded an immediate reform response, it was opinion in the form of a conviction that economic liberty mattered and would work that led to an era of comprehensive and sustained reform.

Lessons from this era:

Policy settings that maintain a big inefficient state with a high level of intervention and prefer protectionism and privilege will cause a misallocation of resources and fail to lift productivity levels. That will in turn lead to chronic state debt and deficits, chronic un-competitiveness, and a suppression of innovation and entrepreneurship.

Only structural reforms can break this vicious cycle. There is a "cost" to reform in the sense that the process of Schumpeter's "creative destruction" occurs, yet the cost of doing nothing is far higher.

Overview of New Zealand's Reforms

The New Zealand economic reforms took place under two governments, starting in 1984, and in the course of ten years transformed our economic performance. Few other countries have undertaken reforms of such far-reaching scope or mutual consistency. As the OECD put it in its 1996 Survey of New Zealand:

> "While other OECD countries have pursued similar policies, few, if any, have done so in the context of such a coherent overall framework, stressing predictability, transparency and accountability."

The reforms included:

- The internationalisation of the economy through the reduction of border protection and abolition of exchange controls.
- Wholesale domestic deregulation in both goods and factor markets, including major liberalisation of the labour market.

- The transformation of government through the corporatisation and privatisation of state trading activities, and major performance management reforms to the core state sector.
- The focusing of monetary and fiscal policy on sound medium term objectives rather than short-term and unsustainable objectives. Monetary policy is now dedicated to price stability and fiscal policy to reducing debt and running balanced budgets over time.

In sum, the reforms greatly increased the role of market forces in creating wealth, while putting in place a sound macroeconomic framework to ensure that poor monetary and fiscal settings would not compromise the benefits from the new microeconomic climate.

What We Did: The Reforms in Detail

The New Zealand economic reforms spanned a period of almost exactly ten years. The first initiatives were taken in July 1984, and the last major reform was completed when the Fiscal Responsibility Act went through its final stages in the House of Representatives in June 1994. Two administrations share the credit for the reforms. The first was the Labour government that took office in July 1984, was re-elected three years later, and then lost office in November 1990. The incoming National administration (New Zealand's "conservative" party) gave new impetus to the reforms, and was re-elected in November 1993.

The New Zealand reforms were unprecedented in scope anywhere in the western world, and presented the sharpest contrast with the policy regime of the past. The key principles driving the reforms included:

- The abandonment of current account balance as a *direct* objective of government policy;

- The abandonment of fiscal policy as a means of short-term fine tuning, and instead the adoption of a medium term fiscal strategy aimed at controlling government spending and eliminating the deficit;
- The assignment of monetary policy to the sole objective of achieving, and then maintaining, price stability;
- An abandonment of the use of economic policy instruments for *distributional* objectives, and an acknowledgment that concerns over income adequacy, or over the distribution of income, are best addressed explicitly through the tax and benefit system;
- A new emphasis on the value of competitive markets and the role of the price system in the efficient allocation of resources;
- A determination to expose New Zealand business, where possible, to international competition, without subsidies, tariffs or other artificial barriers;
- A belief that the tax system should be as neutral as feasible between different types of activity;
- A switch from a bureaucratic regime in the state sector to a modern performance management approach;
- In all areas of policy, a concentration on the medium term implications of policies rather than their short term effects.

At the heart of the reforms was a recognition that resources had not been well employed in New Zealand, and that only by exposing industry to market forces and to much greater international competition could we transform New Zealand's economic performance. There was thus a strong philosophy of economic liberalism: free markets were seen as the chief engine of medium term economic growth. There was also an appreciation that the excessive short-term focus of macro-economic policies had been severely damaging to the

economy. Monetary and fiscal policy needed to be disciplined in a way that was consistent with a sustainable medium term growth objective.

One of the most distinctive features of the New Zealand reform programme was its concern with the concept of "government failure", as understood by theorists of the public choice school. In general, governments can be expected to act in their own self-interest; there is no guarantee they will follow policies that maximise the overall welfare of their citizens. In New Zealand there was a search among policy makers for institutional rules that would bind governments, as much as possible, to sound macro-economic policies, even when the short-run incentives of governments are for unsound policies. Measures such as the Reserve Bank Act and the Fiscal Responsibility Act can only be understood in this context.

The key initiatives of the decade of reform can be summarised as follows:

- The floating of the New Zealand dollar;
- Deregulation of the financial sector, including the abolition of exchange controls, the lifting of interest rate controls, the abolition of reserve asset ratio controls on banks and the development of a new regime of prudential supervision;
- The Reserve Bank Act, conferring price stability as the primary goal of the independent Central Bank's management of monetary policy;
- The introduction of a flat-rate value-added tax (GST), cuts in marginal income tax rates, and a series of measures to broaden the tax base and eliminate anomalies in the tax system;
- The introduction of freedom to contract in the labour market through the Employment Contracts Act;
- The elimination of most direct subsidies to both pastoral and manufacturing exporters, the phasing out of import licensing and the substantial phased reductions in tariffs toward low or zero rates;

- Other deregulations, including the removal of a number of specific price controls, the liberalisation of air services and coastal shipping, and the introduction of competition into electricity and telecommunications;
- Reform of social transfers with the aim of containing costs and concentrating government assistance on the needy;
- A series of measures to bring greater focus, discipline and transparency to government spending, including the State Sector Act, the Public Finance Act and the Fiscal Responsibility Act;
- The corporatisation - and in many cases privatisation - of state trading activities;
- Modernisation of the core state sector with decentralised management and results-based personnel and financial reporting systems;
- Separation of the funding from the provision of many services—e.g., health and science.

Some of these reforms are by no means unique to New Zealand. In many areas, however, New Zealand has been a pioneer. For instance, the Reserve Bank Act and the series of public sector reforms culminating in the Fiscal Responsibility Act show New Zealand to be a world leader. New Zealand has also achieved one of the freest labour markets of any OECD country, as well as the least distorted tax system.

Early Reforms

The initial pace of the New Zealand liberalisation programme was rapid. Before the new Labour Government had even been sworn in, it had moved to devalue the exchange rate by 20%. At the same time, it lifted all controls on interest rates. These measures were sufficient to diffuse the government's immediate crisis - the run on the New Zealand dollar.

A succession of initiatives followed to liberalise financial markets. The system of reserve asset ratios applying to financial institutions was abolished. Monetary policy henceforth operated, not by direct controls on individual banks, but by controlling the amount of base liquidity in the total financial system. All exchange controls were abolished. Then, in March 1985, the New Zealand dollar was floated. Ever since then, the Reserve Bank of New Zealand - our central bank - has run a "clean" float: there has been no buying or selling on the foreign exchange market with the intention of directly influencing the value of the New Zealand dollar.

Floating the currency had two principal motives. It assisted monetary policy by giving the authorities better control over the monetary base than is possible under a fixed exchange rate regime. There was also a belief that a floating exchange rate had an important role to play in resource allocation. Like other prices, it is a mechanism through which important signals are transmitted to participants in the economy.

The exchange rate float has been successful in gaining independence for monetary policy. In the early years of the reforms, however, it is questionable whether the floating exchange rate assisted overall resource allocation. This was because of the imbalances elsewhere in the reform programme.

The opening months of the reform programme saw major cutbacks in industry assistance, with the biggest reductions in the area of agricultural subsidies. Despite the previous government's attempts to diversify the export base, primary products in 1984 still accounted for around two thirds of total export earnings. Direct assistance to both pastoral and manufacturing exports was now rapidly phased down. The scaling back of import protection proceeded at a much slower pace. Though import licensing was being phased out, tariffs remained very high by international standards during the early phase of the reforms.

Tax reform in New Zealand was of consistently high quality. The tax structure inherited in 1984 had been heavily reliant on direct rather than indirect tax, had contained numerous loopholes, and - unsurprisingly - had resulted in very high marginal rates of direct taxation. The new government introduced a flat rate value-added tax on virtually all goods and services. Goods and Services Tax (GST) replaced the existing varying-rate sales tax, and allowed marginal rates of income tax to be substantially cut. Difficult to evade, easy to comply with and even in its incidence, GST proved a model of tax reform. Other reforms were also made to broaden the tax base and eliminate loopholes.

Another highly successful reform was the revamp of many government trading activities into state-owned enterprises (SOE's). Formerly inefficient and unaccountable organisations were transformed into companies facing a single main objective - profit maximisation. The environment for the new SOE's replicated, as much as possible, the environment faced by private companies. As a result of these new incentives, large efficiency gains were rapidly achieved by virtually all of the SOE's.

Gaining control over the huge inherited fiscal deficit proved a much more difficult task. The government's initial moves to scale back industry assistance yielded important savings. Also fiscally positive - as well as justified on its own terms - was the move to price government-provided goods and services on a more economic basis. Other fiscal savings proved harder to achieve, with the result that the deficit remained too large in the early years of reform. Inflation was climbing after the freeze, given impetus by the high post-freeze wage rounds and then by the one-off introduction of GST. Monetary policy over this period had tightened considerably, having adopted an explicitly anti-inflationary stance. The combination of tight monetary policy and much looser fiscal policy saw high real interest rates and upward pressure on the real exchange rate for much of the period 1985-1987. The high real exchange rate was not assisted by the slow pace at which import protection was being reduced relative

to the fall in export assistance, nor by the removal of the wage freeze without accompanying measures to tackle institutional monopolies in the wage setting process.

The Middle Period of Reforms

The second term of the Labour Government - re-elected to office in August 1987- is generally regarded as a period in which the momentum of reform slowed. While this may be true, and while economic policy over this period never succeeded in ridding itself of all imbalances, reforms were still pushed ahead on a number of important fronts: further reductions in import protection; a substantial privatisation programme; and key institutional reforms in both monetary and fiscal policy, as well as fundamental restructuring of the core state sector. This progress was made despite an increasingly difficult economic environment: output was stagnant over the calendar years 1988-1990, while unemployment rose strongly as employers rationalised their labour forces in response to weak demand and new competitive pressures. This period saw the focus of economic adjustment shift from the rural to the urban economy.

Early in its second term the government announced it would undertake an extensive privatisation programme. The government owned many businesses suitable for sale, and the corporatisation process had added substantially to this pool. Over the next three years the government sold almost $10 billion in assets, mostly by open tender, including the sale of New Zealand Telecom. The corporatisation of government trading activities also continued.

Faster progress was now being made in reducing import protection, particularly through the announcement of a staged reduction in tariffs for most goods, in five steps, between 1988 and 1992. This programme brought tariff rates down by a further 50%, on average, with higher rates falling faster than lower rates. The government also continued its programme of tax reform. By 1989 the OECD was able to say that New Zealand's tax system

was “probably the least distorting” of all its member nations - a statement that remains true today.

Inflation fell rapidly in the course of 1988, in response to the tight monetary policy that had applied since 1985. But the disinflation process was not yet over. To further reinforce the credibility of its monetary policy the government announced a target of 0-2% inflation by 1992. More importantly, in 1989 the government passed the Reserve Bank Act, which transformed the institutional environment under which monetary policy operated.

The Reserve Bank Act was motivated primarily by a concern to reduce the potential for monetary policy to be misused-used by politicians for short-term ends, as had often happened in the past. The Act placed the Reserve Bank onto an autonomous but accountable footing. The Act recognised that, in the medium term, inflation is the only economic variable capable of being controlled by monetary policy. Accordingly, the Act specified price stability as the principal objective of the Reserve Bank, while the bank was made accountable to parliament for its performance in pursuit of that objective. There is provision in the Act for the government of the day to temporarily override price stability as the primary goal of the Reserve Bank, but any such instruction from a government must be made public. The public nature of the override makes it very unlikely that any government would make such a move. The Act thus constitutes a powerful mechanism for reinforcing the credibility of monetary policy.

On the expenditure side, major changes were occurring to the way in which core governments managed their resources. Previously government financial management had been highly centralised, and had largely consisted of accounting for inputs. Departmental objectives and responsibilities were blurred at best, and departments had very little autonomy over the way money was spent. This situation changed markedly with the State Sector Act (1988) and the Public Finance Act (1989), which improved both the focus and the culture of

government departments. Departments were now required to specify their outputs. Ministers were able to choose which outputs they wished to "purchase" from their departments. Departmental chief executives were put onto five-year contracts, and became directly responsible to their ministers for delivering the chosen outputs. Chief executives also gained much greater operational flexibility in their use of inputs, so could now be genuinely held accountable for their department's performance. The new system not only provided much better incentives for efficient resource use. It also allowed ministers to assess priorities, and to make informed trade-offs over which departmental outputs they wished to purchase.

Despite the improvement in the institutional environment for conducting fiscal policy, the government still struggled over this period to contain the budget deficit; any progress achieved was made through increasing tax revenue rather than reducing government spending. Expenditure on social programmes was expanding, partly owing to the cyclical downturn in the economy, and the fiscal deficit remained a problem right through the second term of the Labour Government. Both fiscal and monetary policy were still putting pressure - albeit reduced - on the real exchange rate. Along with fiscal policy, the failure to reform the labour market remained an anomaly in the reform programme, as did the still high - though falling - levels of import protection.

Final Round of Reforms

The final round of reforms was undertaken by the National Government, elected to office in October 1990. The government's initiatives removed the last substantive imbalances in the reform programme, and put New Zealand into a position to enjoy sustainable economic growth.

One of the most important initiatives of the entire decade of reform was Employment Contracts Act (1991), which transformed the rules by which the labour market operated. The Act abandoned the antiquated system of national awards that had so long prevailed, and

instead provided, in large measure, for freedom to contract in the labour market. In so doing, it turned New Zealand from having one of most inflexible labour markets in the OECD to having one of the freest and most flexible.

Under the Employment Contracts Act, there is very little proscription of the types of contracts employers and workers can enter into. Workers can be covered by a collective contract or by an individual contract. Employers can negotiate a mixture of collective contracts and individual contracts with their workforce. Union membership is no longer compulsory. A worker is free to choose his or her own bargaining agent when negotiating with their employer. Strikes are seen by the Act as a breach of contract, and are only permitted where they relate to the negotiation of a collective contract for the employees concerned. All other types of strike - including sympathy strikes - are unlawful.

While both collective contracts and individual contracts are permitted under the Act, it does not favour one type of contract over the other. The essence of the Act is choice. Whether to have a collective or an individual contract is itself a matter for negotiation between employer and worker. There is little to stop any individual worker coming together with any individual employer and striking their own deal, if that is what the two parties desire.

The National government continued the programme of other micro-economic reforms undertaken over the previous six years. More state assets were privatised, including the Bank of New Zealand - the country's largest bank as well as the State owned rail company. In 1991 a further global tariff reduction programme was announced, in which tariff rates would be cut in four stages by a total of around one third, from 1993 to 1996. In 1994 the government announced another staged fall in tariff rates.

The government also made major reforms to social spending. The principles driving these reforms were fairness and affordability. Social welfare benefits were cut, abolished or more tightly targeted, both in order to achieve fiscal savings and to increase the margin

between earnings in the workforce and earnings from a benefit. Housing assistance was rationalised so that people in equal circumstances were treated equally, with the tax system used to deliver an accommodation supplement or voucher. The public health system was restructured so as to separate out the funding of health services from their provision. Substantial savings were made through changes to New Zealand's state pension scheme, and a multi-party agreement was reached on its main parameters. These and other savings lead to a substantial fall in government spending, from 39% of GDP in 1991/92 to under 35% by 1994/95. In 1993/94 New Zealand achieved its first fiscal surplus for a generation.

That year the government also passed the Fiscal Responsibility Act (1994). This Act sets down in legislation extensive and rigorous criteria for fiscal reporting. Already New Zealand had been the first country in the world to develop a full balance sheet for its central government, and an operating statement on an accrual basis. The new Act formalised these, and other, elements of government financial reporting into law. It also required the government to publish a full economic and fiscal update just prior to each general election, so that no government could hide from the electorate the consequences of irresponsible fiscal policy. New Zealand now has the most complete and open fiscal reporting of any country in the world.

The Fiscal Responsibility Act goes further: it requires the government to conduct fiscal policy in accordance with a set of "principles of responsible fiscal management". These principles include reducing government debt to "prudent" levels and, once prudent debt levels have been reached, running budgets that are roughly balanced over time. Any departure from these principles by a government must be temporary. It must also be entirely transparent - the government is compelled to explain publicly why it is not conducting policy in accordance with the principles of responsible fiscal management, and how it intends to return to those principles.

The Fiscal Responsibility Act thus provides a powerful discipline on New Zealand governments. It does so without falling into the trap of imposing overly simplistic rules, and without compromising any government's right to set its own priorities in fiscal policy. The Act largely completes the series of reforms that have, since 1984, transformed the framework of the New Zealand public sector. In the opinion of *The Economist* magazine, the Fiscal Responsibility Act, together with the Reserve Bank Act, gives New Zealand the best macro-economic policies of any country in the world.

Lessons from this era:

- Breaking the cycle of poor performance largely lies with putting one's own house in order;
- Good governance and good policy are the two crucial drivers of better performance;
- The willingness to be a policy pioneer marked New Zealand out as a centre of excellence, attracting investment, boosting confidence and activity levels;
- New institutional rules of the game particularly in monetary and fiscal policy locked in the reforms;
- Maintaining reform momentum is of the essence, but easier said than done;
- The economics of structural reform are easy; the politics are hard.

Managing Reform: How Best to Handle the Politics of Reform

A crucial component of New Zealand's reforms was the strong commitment from key political players. The most successful periods of reform were characterised by a clear strategy among ministers, and a consistent application of that strategy throughout the public sector. The poor performance of the economy, and the powerful vested interests opposed to change, meant that a sense of urgency was important in maintaining the momentum of reform.

Just as important was the placing of high quality people in key public sector positions, to ensure that the vision of the reformers was not frustrated during the implementation stage by a bureaucracy resisting change. Effective communication of the rationale for the reforms was crucial. Business needed to understand the overall reform strategy, so as to be in the best position to realise its benefits. And a sufficient percentage of the public needed to be persuaded to give reform the benefit of the doubt during a testing initial period when the adjustment costs outweighed any tangible benefits.

Securing the support of key private sector groups to the cause of reform was an important factor in securing public acceptance of the liberalisation programme. So too was the overall resolve of the government: as the reforms proceeded, sector groups typically gave up demanding to have their privileges restored, and instead started urging the government to treat them even-handedly by moving to reform those sectors that were not yet liberalised.

The *Financial Times*, in an article entitled "Lessons from the Antipodes" [12 March 1996], stated that: "New Zealand has demonstrated that orthodox economic reforms, energetically executed, can make a difference to an economy's prospects. For this reason, it offers important lessons."

In my view the most important of these lessons are:

- The value of comprehensive reform. The New Zealand reforms were both microeconomic and macroeconomic. They encompassed capital and labour markets, goods markets and the government sector.
- The importance of balance in reform. The New Zealand economy began its period of sustainable economic growth only after the last principal obstacles to growth (namely an inflexible labour market and government overspending) had been effectively tackled.

- The value of a medium-term focus. All New Zealand's principal reforms had such a focus.
- The value of political commitment, a clear strategy and high-quality implementation by key people.
- The importance of effective communication.
- A sense of urgency in reform.

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Concluding Remarks

We possess a considerable body of theory and international evidence concerning the role of government, and the type of policy regime that most encourages economic development. Too often, however, political considerations and the demands of vested interests prevent a government from acting in a manner consistent with sound outcomes.

We know that open and competitive markets are the most effective generators of wealth over any reasonable period of time. The role of the government is to support markets by maintaining a consistent and predictable legal framework, involving few restrictions on contracting and maximum transparency in the conduct of economic policy. While this may sound a comparatively minor task for government, it is a crucial role, which is performed well by few countries anywhere. One of these countries is New Zealand.

Credibility

Much that is important in governance ultimately comes down to issues of **credibility**. Does the government adhere to a consistent set of principles, and pursue policies that are not in contradiction with each other? Can private sector participants make decisions in the confidence that the government will act predictably in given circumstances? And at the level of implementation, will policies be carried through in a manner consistent with maintaining and strengthening the entire culture of a market economy?

New Zealand's reform programme largely meets these tests of credibility. For instance, by making fiscal policy more predictable, transparent and accountable, the Fiscal Responsibility Act has improved the credibility of government, transformed the nature of the political debate on fiscal policy, and assisted materially in generating better private sector performance.

Institutional Design

The outcomes from the Fiscal Responsibility Act illustrate how improved **institutional design** has a positive impact on the behaviour of participants in the economy, both in the public and private sector.

Many other New Zealand institutional reforms also demonstrate this principle. For example, the discipline provided by the Reserve Bank Act has led successive governments to pursue price stability in preference to policies that favour the short-term at the expense of the medium-term. That Act has also changed private sector behaviour by reducing inflation expectations and business uncertainty.

The new institutional framework under the State Sector Act 1988 and the Public Finance Act 1989 promoting a performance management regime involving accountability and transparency throughout the public sector - such as the requirement to produce a departmental balance sheet - has improved performance at all levels.

And in the labour market, the change in framework under the Employment Contracts Act 1991 from centralised bargaining to free contracting has led to big cultural changes at the level of the firm, in the form of greater co-operation between employers and employees, increased flexibility, and reduced industrial conflict. Correct design of the institutional framework clearly makes a big difference to economic performance.

Good governance is epitomised by a framework of policies that are consistent, transparent, predictable and credible. The State should not attempt to perform tasks that are

the proper province of the private sector, but should rather provide the overall climate within which markets can flourish.

Private sector participants, for their part, must be prepared to take the lead in investment decisions, and look to their own skill and resource in the search for higher productivity, rather than seek to be rescued by government rules that confer privilege on them while raising costs on others. And private sector participants must observe the legitimate rules of competitive markets and stay within the law.

Policy Emphasis and Execution

Policy emphasis will be dictated by the country reality. For Argentina, the cause of defeating hyperinflation prevailed as the top priority. For the United Kingdom the grip of trade unionism made labour market flexibility a top priority. For much of Asia securing sound financial systems and the liberalisation of markets have been the things that matter most.

For **New Zealand**, our reality is different again. We are a small geographically isolated country with a traditional economic reliance on land based commodity production. Realising our ambitions will require us to be more competitive and clever, just to overcome the disadvantage of size and distance.

While constitutional frameworks and electoral systems differ, successful policy reform has common characteristics.

1) *Leadership* - each nation needs a "Caesar", a champion who develops a vision that excites the citizens and persuades them of the merit of change
2) *Sense of urgency* – drift and denial are the twin enemies of successful transformation
3) *A team of believers* – the "power of one" is not a formula for successful transformation. A guiding coalition within the Government and reaching out into

opinion leaders from the private sector and from civil society is essential to create a constituency for change.

4) *A "General" who is responsible for the implementation of the reform strategy* – the movie "The Gladiator" is a powerful story that demonstrates a winning combination at work; the leader and his general. Every Caesar needs his Maximus [who incidentally is played in the movie by a kiwi actor, Russell Crowe]. Every leader with an ambition to reform must ensure that a "general" is installed in the administration. That person may typically be the Minister of Finance, although in some countries a special Minister of Reform portfolio has been created. The General is the person who must make good the leader's reform promise.

5) *"Seeing is believing"* – Citizens will be sceptical of reform until they can see the dividends. Generating short term wins should be at the forefront of the reformers minds as they think about the pace, the sequence and the execution of the changes.

6) *Communications strategy* - Reform is a demanding task and it is all too easy for the reformers to become so absorbed with planning the design and execution that they neglect the communications imperative. In the case, say, of a big utility privatisation, it's not just enough to sell the asset; reformers have to put equal emphasis on selling the story of why the reforms make economic and social sense.