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Institutions and Policies Matter Most for Prosperity

The Confidence and Supply Agreement between the National and ACT parties released last weekend commits them to pursuing the “concrete goal of closing the income gap with Australia by 2025.”

This is arguably the most important element of the agreement. It is a major challenge, and will require a sustained lift in New Zealand’s productivity growth rate to 3% a year or more, as the agreement acknowledges.

Both parties “recognise that achieving this goal will require significant improvements in New Zealand institutions and policies.”

Most people understand what is meant by policies. But what are institutions?

By institutions, economists mean both formal institutions such as constitutional arrangements and the system of government, as well as informal institutions such as trust, codes of moral behaviour and the absence of corruption in a society.

The International Monetary Fund’s April 2003 *World Economic Outlook* found that three-quarters of the variation in average income per capita around the world could be explained by differences in institutional quality.

By contrast, the economic literature suggests that factors such as population size, distance from markets, endowment of natural resources, the ratio of trade to GDP and cultural differences are at most minor determinants of a nation’s prosperity.

Institutional quality improved greatly in New Zealand with the economic reforms of the 1980s and early 1990s.

Landmark changes included 'economic constitutions' in the form of the Reserve Bank Act and the Fiscal Responsibility Act. These constrained executive government in its monetary and fiscal operations respectively.

To these could be added the State-Owned Enterprises Act, the State Sector Act and the Public Finance Act, which introduced better disciplines into public sector operations, as well as reductions in barriers to international trade and capital flows and liberalised regulatory frameworks for many internal markets.

Institutional quality began to deteriorate with the introduction of the mixed-member proportional voting system (MMP) at the 1996 general election. Proportional systems make the removal of governments from office more difficult, and research indicates they are associated with higher levels of government expenditure and more protracted and compromised policy-making.

While New Zealand has retained many sound institutions, including the British common law, there was further deterioration in institutional quality under the recent Labour-led government.

In general this took the form of a move away from principles of limited government towards an open-ended vision (most memorably encapsulated in former prime minister Helen Clark's statement, "The government's role is whatever the government defines it to be").

Notable instances of institutional change have included:

- the widening of the Reserve Bank's inflation target to 1-3 percent in the Policy Targets Agreement, and the apparent abandonment by the Reserve Bank of the legislated goal of price stability;
- the 2002 Local Government Act which expanded the purposes of local government and gave councils a power of general competence;
- an erosion of respect for property rights;

- the replacement of the internationally respected Privy Council by a New Zealand Supreme Court;
- the undermining of the capacity and independence of the public service through political interference;
- the passage of the Electoral Finance Act with its chilling effect on free political speech;
- disrespect for the rule of law in the intervention to block the bid by Canadian interests for a shareholding in Auckland International Airport; and
- a massive increase in regulatory burdens, renationalisation of industries, an expanded, wasteful, and inefficient public sector, and entrenched inflation and inflationary expectations.

These changes to institutions and policies had predictable outcomes. After maintaining its momentum for some years on the back of the earlier reforms (and favourable external circumstances), the economy entered recession in the first quarter of this year, well before it was hit by the international financial turmoil.

Reversing these trends will require reversing the deterioration in institutional quality and policies, and building on the earlier improvements. There is no reason why New Zealand cannot match Australian per capita income levels by 2025, given outstanding economic management.

Action will be needed across a broad front, and will need to be maintained consistently, not in an erratic fashion. The Confidence and Supply Agreement contains some important elements of a programme that would improve institutional quality.

Two of them are proposals to strengthen the Fiscal Responsibility Act (now part of the Public Finance Act) by placing a cap on the growth of government expenditure, and to implement a Regulatory Responsibility Act along the lines of a bill considered by a select committee earlier this year.

Overall, better institutions and policies, with government limited to its proper role of ensuring the provision of genuine public goods and a safety net, which promote greater economic freedom and provide maximum scope for entrepreneurial endeavour in the private sector, must be the foundation of any programme to achieve greater prosperity for New Zealand.

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