Why Have Kiwis Not Become Tigers?

Reforms, Entrepreneurship and Economic Performance in New Zealand

FREDERIC SAUTET

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Why have Kiwis not become tigers?

The New Zealand economy is noteworthy in policy circles for its turnaround during the 1980s and early 1990s. Starting from a state of semi-autarky in the early 1980s, the country now has a much more flexible and efficient economic structure. In the 15 years to 1999, successive governments reformed its institutional environment by injecting high doses of deregulation and opening the economy to the world.

Following these changes, New Zealand climbed up various indexes of economic freedom: its score increased from 5.9 in 1985 to 8.2 in 2003 on the Fraser Institute measure (Gwartney and Lawson 2005). Strong employment growth from the early 1990s and productivity gains increased economic growth. Yet its average growth rate in the past decade does not compare with that of the Asian tigers, Singapore and Hong Kong, or that of Ireland, Estonia and Luxembourg, countries that share some of the highest ranks in the index.

Recent performance and the modest growth prospects for the years ahead have fuelled the debate about the success of the New Zealand reforms. Some economists think that the less than stellar economic performance results from the failure to complete the reform process. Others believe that the current situation is the result of too much reform: New Zealand has been a 'laboratory' for free-market policies, and they went too far. Some maintain that it is now time to go back to more middle-of-the-road policies, taking into account not only economic efficiency but also income distribution, the environment and other issues said to have been left out in the reform process.[1] In this view, better 'management' of the economy should help to improve growth prospects. The Labour-led government espoused this opinion when it was elected in 1999 (Kay 2000). Still others think that owing to New Zealand's cultural heritage, its inhabitants are relatively uninterested in high levels of economic growth.[2] New Zealanders, it is said, do not need much money to be happy because they hold dear some egalitarian ideas that go back to the nineteenth century, reflected today in the romantic search for a peaceful and green New Zealand and perhaps also in the revival of Maori tikanga.[3]

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1 A recent instance of this debate is John McMillan's 2004 observation that "markets are doing their job" and the lack of higher growth must be found elsewhere (in geography, lags in adjustment and so forth). Kerr (2005c) notes that growth since 1999, though reasonably fast, has not been faster than the average of the 1990s, which shows that the new Labour government policies have not had, as of yet, the impact their supporters claimed for them.

2 Tyler Cowen entertained this idea on his web log. Aidan Walsh told me that the same was said about Irish people before the 1990s.

3 The customs and traditions of Maori.

With improvements on a raft of indicators including inflation, employment, public debt, productivity and per capita income growth rates, it is now clear that the reforms have been hugely beneficial to the economy. Contrary to its earlier views, the Labour-led government now recognises their importance. As the December Economic and Fiscal Update 2004 stated:

> New Zealand's recent growth performance can be attributed to past structural reforms that began in the mid-1980s; which have resulted in a trend increase in New Zealand's growth rate since the early 1990s . . . a more flexible economy better able to absorb adverse shocks and take advantage of favourable shocks, and sound macroeconomic policy settings (quoted in Kerr 2005c, 1).

This support is not wholehearted: the phrase "failed policies of the past" has been used by some politicians to disparage what was done during the reform period. However, a consensus is now emerging that the reforms made the economy more vibrant and prosperous. They have had a very positive impact on the entrepreneurial environment; unemployment is low; and trend growth is around or above the Organisation for Economic Cooperation and Development (OECD) average. Most commentators today recognise these improvements.

In the long run, what matters for prosperity and growth is the quality of the entrepreneurial environment. When the institutional and cultural environment enables individuals to discover and seize profit opportunities, growth occurs (Boettke and Coyne 2003; Sautet 2005). Taking this factor into account, I argue here that:

- the reforms have vastly improved the entrepreneurial environment, and, as a result, given the starting point, have greatly enhanced New Zealand's economic performance;
- to go beyond current levels of economic performance, there is a need to improve the entrepreneurial environment further. New Zealand failed to become a growth miracle because the reforms that were implemented, though good, were not exceptional.

In the first section of this report I describe the context in which New Zealand's reforms took place and then consider the five main reforms that did most to improve economic performance. In the third section, I examine the reasons why New Zealand is not performing like an Asian tiger and discuss some policy implications.

Background to New Zealand's reforms

Much has been said about New Zealand's two main waves of reform in 1984–88 and 1990–91. In the words of David Henderson, formerly an OECD senior official, the reform period in New Zealand was "one of the most notable episodes of liberalisation that history has to offer" (Henderson, 1996, 13). Let us consider the context in which these reforms took place (for more detail see Evans *et al*, 1996).

A long time ago, in a country far away

To understand the context of the 1980s, one must go back a hundred years. At the end of the nineteenth century, New Zealand was, along with Germany, one of the first

countries in the world to implement comprehensive social legislation. Even before the ravages of World War I created a demand for social assistance in Western countries, New Zealand stood at the forefront of social policies. For example, women obtained the right to vote in 1893. Labour market reforms were introduced in 1894 in the form of a compulsory arbitration system, and a pension scheme was set in place for the 'deserving poor' in 1898. The expectation slowly developed that the state should provide 'cradle to the grave' protection against life's hazards.[4] From the late nineteenth century to the 1920s, the country was one of the five richest countries in the world as measured by gross domestic product (GDP) per capita. This wealth came from exports of farm produce to Britain (thanks to the advent of refrigeration) and from high productivity in agriculture, which reflected a small population and an abundance of fertile land.

During the 1930s, as in many other countries, the rise of protectionist policies in New Zealand (for example, import licensing in 1938), along with an expanding welfare state, harmed economic performance. Many additional economic controls were introduced in World War II, and after the war the country maintained inward-looking policies. Despite buoyant periods, such as the Korean wool boom in the early 1950s, New Zealand's international ranking for gross national product (GNP) per capita deteriorated further in the post-World War II period.

As Evans and his co-authors explain, New Zealand's GNP per capita in 1938 was 92 percent of that of the United States. By 1950, the ratio was 70 percent, and by the 1980s it was 50 percent (1996, 1860). In other words, over a period of almost 50 years, New Zealanders experienced a steady relative decline in their standard of living. Whereas Australia's decline in relative income per capita levelled off in the 1970s and the United Kingdom bounced back in the 1980s, New Zealand continued to sink, to around twentieth rank when the reforms started in 1984.

By the 1970s, New Zealand had the most regulated economy in the OECD. Until 1973, when it joined the then European Economic Community (EEC), the United Kingdom represented the main export market for New Zealand products. Subsequently, however, access was reduced, and the consequences of the post-war policies became more apparent. New Zealand had become a semi-autarkic economy, the so-called 'Fortress New Zealand'. By the end of the 1970s, more and more young people were leaving the country. They found overseas experience not only necessary but also preferable to the opportunities offered at home.

Besides retaining foreign exchange controls, high tariffs and import licensing in an attempt to control the balance of payments, the New Zealand government adopted many other harmful policies during the 1970s. Revenues from high taxes were used to provide subsidies to many major industries. Agriculture, for example, enjoyed large subsidies and many producer boards were statutory monopolies. The government used the public employment model of welfare to maintain wages and employment by adding to the

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[4] For a general history of New Zealand at the turn of the twentieth century, see King 2003, especially chapter 18. Before the enactment of social legislation, the government had an active role in land acquisition and infrastructure development.

payrolls of government-owned enterprises, thus keeping the recorded unemployment rate artificially low. As in many Western countries at the time, inflation was rampant (between early 1970 and late 1984, it averaged almost 12 percent per year), and wage and price controls were (unsuccessfully) employed to limit its effects. The labour market was highly regulated. Under a 'crawling peg' (fixed but adjustable) regime, the exchange rate was fixed in the early 1980s at a level that eventually became no longer credible, given loose monetary policy and weak terms of trade.

As a result of such policies, government spending rose from approximately 22 percent of GDP in 1970 to more than 35 percent by 1983, and government debt rose from approximately 5 percent to more than 30 percent of GDP; it continued to grow to 51 percent by 1992. Although these trends were not exceptional – indeed, they were common to most countries in the Western world – their effects, combined with extensive market regulation and state ownership of many enterprises, stifled growth and led to the relative impoverishment of New Zealand's people. Unemployment, negligible in the 1960s, was pushing above 4 percent of the labour force by the late 1970s.

'There's got to be a better way!'

The first attempts to reform the economy were made in the late 1970s with liberalisation of import licensing and deregulatory moves in the transport and meat processing industries. Roger Douglas, an opposition politician who would later become the architect of the first wave of reforms, proposed important economic changes in 1980.[5] The Treasury had been advocating regulatory and tax reforms without much success before Prime Minister Robert Muldoon implemented the first serious change, signing the Closer Economic Relations (CER) treaty with Australia which came into effect in 1983. At the same time, however, he introduced a comprehensive wage and price freeze and embarked on a major programme of government energy investments (known as Think Big). Moves toward liberalisation were in the air but deeper and more comprehensive reforms did not become part of the agenda until 1984 when the government changed.

In that year, New Zealand faced a severe crisis. As an election neared, market participants lost confidence in the capacity of the Reserve Bank to maintain the fixed exchange rate. Money poured out of the system, and a currency crisis followed. The Reserve Bank lost almost all its foreign reserves and had to close its currency trading window before markets reopened on the Monday following the election. This event initially caused a constitutional crisis, with the outgoing prime minister refusing to implement the instructions of the newly elected Labour government during the interregnum.

Once this problem was overcome, the new government, led by Prime Minister David Lange and Finance Minister Roger Douglas, devalued the dollar and started making big changes to the institutional landscape. Many reforms took place in the 1980s under Douglas's leadership and were extended in the early 1990s when Ruth Richardson became finance minister with the election of the National government in 1990. These

[5] This proposal was published under the title *There's Got to Be a Better Way!* (Douglas 1980).

far-ranging reforms embraced changes to government spending, taxation, financial markets, other market regulations (especially industrial policy and labour markets), public sector management and social assistance. Although not all were successful (the health sector was extensively but unsatisfactorily reformed during the 1990s, for example), some became models for the rest of the world.

Five reforms that changed New Zealand

It is often said that there is no silver bullet for reforming an economy; economic reforms must be undertaken as a package, and rarely is a single policy responsible for an economy's success. These observations certainly apply to New Zealand, where an ensemble of policies brought about the economy's revitalisation. Among them, however, five areas of policy reform stand out:

- the tax system;
- the labour market;
- international trade;
- monetary policy (including the establishment of Reserve Bank independence); and
- fiscal management.[6]

In this section, I examine the impact of these reforms on the economic (especially entrepreneurial) environment. They ushered in a better tax system, a more flexible labour market, more open markets for goods and services, a stable monetary system, budget surpluses and reduced public debt.

The tax system

In its August 1985 *Statement on Taxation and Benefit Reform*, the government announced the reduction of the top marginal income tax rate and the implementation of a new value-added tax (goods and services tax (GST)) to replace most indirect taxes. The idea behind the changes was to broaden the tax base – that is, to tax hitherto untaxed income and spending – and to reduce high marginal tax rates. The reduction in marginal tax rates would improve efficiency by reducing the deadweight loss of taxation, and the broadening of the base would reduce the incentives to pursue certain activities simply to avoid taxation. The top marginal income tax rate was halved, dropping from 66 percent to 33 percent between 1985 and February 1988. The GST covered almost all sales transactions, excluding exports, at a flat rate that was originally set at 10 percent but increased to 12.5 percent in 1989. Corporate and personal income taxes were integrated by the introduction of an imputation system, which removed the double taxation of income by giving shareholders a tax credit for any tax paid at the corporate level.

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6 Many other reforms also played an important role. For example, competition law was overhauled and simplified (the new Commerce Act of 1986 entirely replaced the Commerce Act of 1975) and markets in energy, transport and communications were deregulated.

The tax system was designed to be a coherent structure that would minimise deadweight losses and reduce administration and compliance costs. One of the most conspicuous results was that most taxpayers no longer had to file a tax return. The tax changes improved the business environment. Investment choices became less influenced by tax considerations, and the tax system did not lend itself to lobbying as much as it had in the past.

In 2000, the Labour-led government increased the top marginal income tax rate from 33 percent to 39 percent for incomes above NZ$60,000. Doing so disrupted the alignment between the company, trust and top marginal income tax rates, and made taxation a more important variable in people's choices. The change increased the potential for tax arbitrage. Even though a marginal tax rate of 39 percent is still not very high by international standards, the move was negative for economic growth, especially at a time of fiscal surpluses. According to Davidson (2005), the threshold of the top income tax bracket as a proportion of GDP per capita is 1.21 for New Zealand. It is only 0.50 for Hong Kong, but that jurisdiction has a marginal tax rate of just 20 percent (19 percent following the 2006–07 Budget). In Singapore, the threshold ratio is 9.53, and the marginal tax rate is reducing to 20 percent. In contrast to other countries, New Zealand's income tax base is very broad.

The tax system creates some problems, especially with regard to the capital–labour boundary and the interface between the welfare system and the income tax schedule. For example, tax credits and other welfare benefits tied to income are abated as income rises. This results in very high effective marginal tax rates, which raise the opportunity cost of increasing one's own income. This inevitably contributes to the creation of poverty traps. Also, the proportion of post-tax to before-tax profits that entrepreneurs can retain affects entrepreneurial activity. The higher the post-tax profits, the more likely previously unknown possibilities to trade will be discovered. The tax system therefore affects entrepreneurial discovery because it influences the pure monetary profit that emerges through exchange (Kirzner 1985a).

Labour market liberalisation

Labour markets have long been regulated in New Zealand. Early landmarks include the adoption of compulsory arbitration in 1894 and compulsory union membership in 1936 (see Baird 1996; Evans *et al* 1996; Kerr 1999, 2005a; Carroll *et al* 2002; Mills and Timmins 2004).

The Employment Contracts Act 1991 was, in Charles Baird's words, "a bold, giant step toward the worthy goal of restoring freedom of contract to New Zealand labour markets" (1996, 1). A consequence of the Act was the replacement, in most industries, of centralised bargaining by decentralised enterprise (or individual) bargaining. It gave employees and employers a choice of individual employment contracts or collective ones, and no special agent (for example, a trade union) was needed to represent the parties to the agreement. In many cases, individuals chose to represent themselves.

The Employment Contracts Act, alongside other reforms, had an enormous impact. The unemployment rate fell from a peak of 11 percent in 1991 to 6 percent by 1996,

and to less than 4 percent by 2004. During this period, the nature of contracts changed dramatically: multi-employer contracts virtually disappeared, and direct contracts between employer and employee became the norm. The labour market became much more flexible and responsive to the needs of firms and individuals.

Labour laws constitute one of the major elements that determine the quality of the entrepreneurial environment. To some extent, a firm is a locus of planning, where entrepreneurs hire the services of factors of production (such as labour) in order to exploit discovered opportunities.[7] Labour is the primary factor in almost all organisations. Therefore, labour law influences the way entrepreneurs can contract with the human resources that are crucial to the capture of profit opportunities. When profit opportunities are discovered, entrepreneurs need to bid away resources already at work in the economy. The process of 'efficient allocation' of resources at the heart of neoclassical economic analysis begins with, and can exist only within, the entrepreneurial discovery process. When labour laws restrict contractual possibilities, they adversely affect entrepreneurial activity by shrinking the resource pool that entrepreneurs can use.

Trade liberalisation

In the 1970s and the first part of the 1980s, New Zealand had one of the least open economies among the OECD countries. As Evans and his colleagues put it, "For most categories of goods there was little variety" (1996, 1883). Many import restrictions set in place during World War II lasted until the mid-1980s. Many goods produced or assembled in New Zealand in the 1970s would have been produced elsewhere had free trade been possible. Entrepreneurs were limited in their capacity to differentiate their goods; trade restrictions stifled the exploitation of comparative advantage.

After the CER agreement with Australia, the next moves to open the economy started in 1984, when the Labour government devalued the New Zealand dollar. Capital flows were also liberalised that year, allowing freer foreign investment in New Zealand and greater freedom to invest abroad. Complete free trade with Australia was implemented in 1990 and tariffs on goods from all other countries were gradually reduced. In September 1998, the National-led government announced plans to remove most tariffs by July 2001 and all tariffs by 2006 – that is, to adopt unilaterally full free trade with all countries. This decision was rescinded by the Labour-led government, which initially imposed a freeze on tariff reductions and subsequently (September 2003) announced a programme of reductions that will see all rates reduced to 10 percent, 5 percent or zero by 2009.

Trade liberalisation dramatically increased the range of goods and services available in New Zealand, and the impact on consumer welfare was enormous. Between 1983 and 1993 the ratio of imports plus exports to GDP rose by 42 percent (Evans *et al* 1996, 1883). Trade liberalisation also increased entrepreneurial activity by extending the market available to entrepreneurs, creating an effect similar to an increase in population size.

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[7] See Sautet 2000, especially chapter 2 on the notion of the 'simple firm'.

Monetary policy and the Reserve Bank

The Reserve Bank Act 1989 replaced the 1964 Act and was another stepping-stone in the reform process. Monetary policy had been one of the most inconsistently used instruments of macroeconomic policy, with multiple targets and a lack of accountability (Evans *et al* 1996). The 1984 Labour government took a different approach: monetary policy would no longer be a short-term instrument in the government's hands; it would become a long-term instrument aimed at creating a stable environment by containing inflation. Not only was inflation high in the early 1980s, but inflation expectations were not in line with outcomes: expectations were higher than actual inflation because the credibility of the Reserve Bank was low. This influenced wage-setting and accentuated the rise in unemployment. Reducing inflation and making monetary policy more credible were the main reasons for the enactment of the Reserve Bank Act. Moreover, government borrowing from the Reserve Bank was no longer to be used to finance the fiscal deficit. Deficits would be funded by the issuance of term debt, then eventually reduced and turned into surpluses.

The key elements of the Reserve Bank Act 1989 were: a single focus on price stability and operational independence and accountability.

The inflation target in the first policy targets agreement, reached in 1990, was 0–2 percent inflation (measured in terms of the annual change of the consumers price index). Subsequent policy targets agreements were signed in 1992, 1996, 1997, 1999 and 2002. In 1996, the permitted annual increase in the consumers price index consistent with price stability was changed from a range of 0–2 percent to 0–3 percent. When Dr Alan Bollard took office as governor at the Reserve Bank in 2002, the new agreement raised the bottom of the inflation target range to 1 percent, while retaining the 3 percent upper limit.

Although in 1989 the function of the Reserve Bank was identified exclusively as the maintenance of price stability, its objectives have changed slightly over the years. The intent of the 1989 Reserve Bank Act remains, but broader economic goals are now also part of its mission. As Bollard has stated:

> Price stability is the Reserve Bank's "primary function", but we also seek to avoid "unnecessary instability in output, interest rates and the exchange rate." The shift to an inflation target "on average over the medium term" allows us to better achieve this. This helps economic growth, which, we all agree, New Zealand needs, by enhancing predictability and confidence and, by that, savings and productive investment. The raising of the bottom of the band brings the overall target more in line with New Zealand's inflation outcomes in recent years and those in other countries (Reserve Bank of New Zealand 2002).

Since June 1991, inflation, as measured by the consumers price index, has averaged 2.1 percent, which is within the target band (Reserve Bank of New Zealand 2005) – a substantial achievement, considering the history of monetary policy in New Zealand and outcomes before the 1989 Act. However, the recent changes to the policy targets agreement have established broader goals that cannot be achieved through monetary

policy and will contribute to the deterioration of the quality of the entrepreneurial environment.[8]

A stable monetary environment is important for entrepreneurship. Monetary prices convey information about market demands and supplies that is crucial to the discovery of profit opportunities. Market calculations can be carried out best if money provides a medium of exchange with reasonably stable purchasing power.[9] The presence of price inflation (induced by bad monetary policy) reduces the effectiveness of money to convey accurate information and thereby worsens the entrepreneurial environment.

Fiscal policy and balanced budgets

Public debt in New Zealand rose from less than 10 percent of GDP in the 1970s to more than 50 percent in 1993. When the Labour government took office in 1984, the fiscal position was becoming unsustainable. In spite of immediate measures that were taken, ongoing deficits and large borrowing costs continued to climb during the remainder of the 1980s and into the early 1990s. Part of this debt spiral was the cost of the reforms, but it was also the result of years of bad Keynesian policies. As a consequence of the debt situation, Standard and Poor's and Moody's Investor Services downgraded New Zealand's credit rating for sovereign currency debt; the country lost its Moody's 'triple A' rating in 1984 and did not recover it until 19 years later, in 2002.

In 1984, a programme of fiscal stabilisation was launched. In 1989, parliament adopted the Public Finance Act and, in 1994, the Fiscal Responsibility Act (introduced prior to the 1993 election by Finance Minister Ruth Richardson) was passed.

The Public Finance Act replaced an input-focused system for controlling government base spending with an output-focused one.[10] Although this change was controversial at the time, government departments adapted well to it and became more responsible with taxpayers' money. For example, departments were typically compensated for inflation under the old system but were now required to prove that nominal spending should be increased because cost increases outweighed productivity gains (although it should be noted that many programmes remain indexed and that this constraint was later

[8] As history showed in the 1970s, central bank policies designed to achieve broader macroeconomic results are generally not successful. Looser monetary policy achieves only greater inflation and poorer economic performance in the long run.

[9] The purchasing power of money can never be completely stable. Still, the price inflation that results from increases in the money supply diminishes the purchasing power of money more than other changes in the market.

[10] The Public Finance Act 1989 made other changes. It: (a) provided a framework for parliamentary scrutiny of the government's management of the Crown's assets and liabilities, including expenditure proposals; (b) established lines of responsibility for the use of public financial resources; (c) established financial management incentives to encourage effective and efficient use of financial resources in government departments and Crown agencies; (d) specified minimum financial reporting obligations of the Crown, Crown agencies and government departments; and (e) provided statutory authority and control for the raising of loans, issuing of securities, giving of guarantees, operation of bank accounts and investment of funds.

relaxed). At least until the mid-1990s, this Act had a positive impact on controlling government spending and thus helped to reduce budget deficits and public debt.

Whereas a key focus of the Public Finance Act was on how government departments spent money, the Fiscal Responsibility Act (which, in 2005, became part of a revised Public Finance Act) provides rules for the conduct of fiscal policy.[11] Its goal is to improve policy by establishing principles of fiscal management and strengthening reporting requirements. The five principles laid down are to:

1. increase the transparency of policy intentions and the economic and fiscal consequences of policy;
2. bring a long-term (as well as an annual) focus to budgeting;
3. disclose the aggregate impact of a budget in advance of the detailed annual budget allocations;
4. ensure independent assessment and reporting of fiscal policy; and
5. facilitate parliamentary and public scrutiny of economic and fiscal information and plans.

The Fiscal Responsibility Act contributed to the fiscal stabilisation of the 1990s. The increased transparency of the government's short-term and long-term fiscal intentions and the high standards of financial disclosure improved government incentives. However, the change in the electoral system in 1993 (see below) and the election of a coalition government in 1996 led to higher spending per capita.

The New Zealand government ran an operating surplus of more than $900 million in the 1993/94 fiscal year. This was the first budget surplus in 17 years and was dedicated to debt repayment. Since then, the government has consistently run budget surpluses. Moreover, net public debt in 2004 was down to approximately 10 percent of GDP and was forecast to decline further in the years to come (New Zealand Treasury 2005c).

Although a degree of fiscal discipline is now a reality in New Zealand, it is difficult to establish how much is due to the Fiscal Responsibility Act. The fiscal position also improved as a result of faster economic growth.[12] The Act has had little effect on the growth and quality of government spending. In Bryce Wilkinson's words, the "biggest concern . . . is [the Act's] failure to do more to impose value-for-money disciplines on new and existing government spending" (2004, 13).

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[11] See New Zealand Treasury 2005b. The 1994 Fiscal Responsibility Act was replaced by the Public Finance Amendment Act 2004. In this new legislation, 'fiscal management' replaces the 'fiscal provisions' approach. However, the intent of the Act remains the same, which suggests that even with multiple changes of government the idea of fiscal discipline has, in principle if not in practice, become generally accepted in New Zealand.

[12] See Wilkinson 2004 for an analysis of the impact of the Fiscal Responsibility Act during the 1994–2004 period.

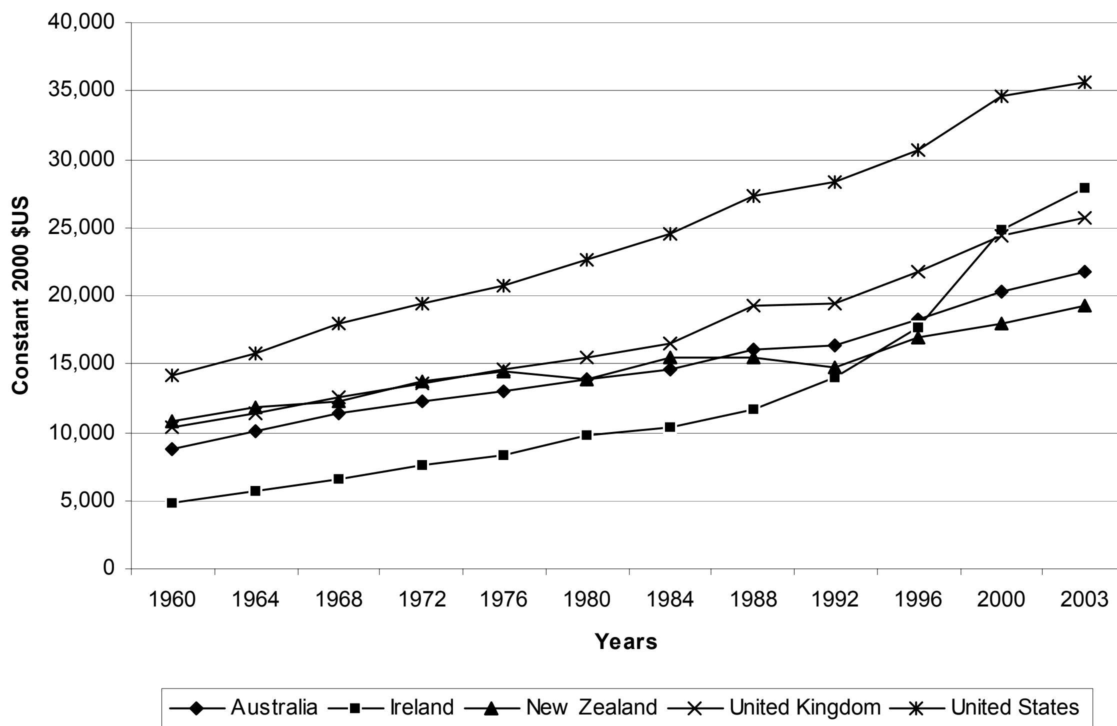
The missing link between Kiwis and tigers

The Irish economy grew annually by 8 percent between 1995 and 2000 (Lynch 2005). This impressive performance surprised many commentators, including some policy makers who participated in the Irish reform process. According to economist Colin Lynch, no magic recipe explains Ireland's economic success. Rather, it springs from a series of reforms that, taken together, changed the business environment in a favourable way. Benjamin Powell (2003) argues that the massive increase in economic freedom in the past 20 years is the best overall explanation of the Irish miracle.

As figure 1 shows, New Zealand's GDP per capita in 1960 was approximately the same as that of the United Kingdom and was considerably greater than that of Australia or Ireland (although less than that of the United States). By 2003, New Zealand was last in this group, well behind the United Kingdom, Australia, Ireland and the United States. More generally, the reforms have not propelled the economy back up the OECD rankings of income per capita, although they have arrested the slide.

In contrast to New Zealand, Ireland has experienced a phenomenal recovery (see figure 1). In 1960, Ireland was the poorest country in the group by a big margin (Irish GDP per capita was less than half that of New Zealand). By 1996, however, after a decade of reforms, Ireland's GDP per capita was higher than that of New Zealand; in 1997, it was higher than that of Australia; and by 2000, it was higher than that of the United Kingdom.

Figure 1: Trends in GDP per capita



The five policy changes discussed earlier have dramatically changed New Zealand's entrepreneurial environment. It has become a reasonably deregulated and competitive market economy, but not a growth dynamo (Wolf 2004). No single factor lies at the root of New Zealand's performance, but rather a series of factors that, taken together, have limited the incentives for entrepreneurs. In the remainder of this section, I examine why the New Zealand economy has not yet become the 'tiger of the South Pacific'.

The size of government

Many commentators on the New Zealand economy do not see the size of government as an explanation of relatively poor economic performance. The New Zealand Treasury (2004) and the Ministry of Economic Development (2005) point to other factors such as the sluggish growth in the investment to GDP ratio.

The ratio of central government spending to GDP in New Zealand has not changed much since the early 1980s. Mainly what has changed is the efficiency of tax collection and the ways tax revenue is being spent. There is evidence that not only the amount of government spending matters, but also its structure and quality. The enormous restructuring of New Zealand's public sector and the improved quality of its decision-making processes have, at least until recently, reduced the government's burden on the economy.

Nevertheless, the proposition that countries with big government do not grow fast has been corroborated empirically.[13] It is true that many OECD countries have big governments, but none of them has grown fast for long periods.[14]

One reason for this relationship is that high levels of government spending cause entrepreneurs to respond to government-created price signals, setting in motion what Kirzner calls the "superfluous discovery process". The discoveries are superfluous because they are based on false profit signals created by government activity. These do not reflect individuals' preferences and, as a result, change the economy's patterns of saving and consumption. False profit signals lead to unproductive entrepreneurship and poorer economic performance (Kirzner 1986, Sautet 2002, 2005).

Another reason for the relationship is that even with improved structures, governments are not capable of acting entrepreneurially. Much government activity involves transferring resources through taxation, not creating value. When cost-benefit analysis is used by governments, it is often, though not always, guesswork.[15]

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[13] See Gwartney, Holcombe and Lawson 1998; Bates 2001; Kerr 2002; and Wilkinson 2004, section 3.4. See also Grimes 2003 for the opposite view when applied to the New Zealand case, and Wilkinson 2004, 35, for a rebuttal of Grimes's view.

[14] The proposition is that no OECD country has achieved sustained growth of GDP per capita of 4 percent or more annually with total government outlays at 40 percent of GDP (Wilkinson 2004). New Zealand's total government outlays are estimated at 38.5 percent in 2006, Ireland's at 35.2 percent and Australia's at 35.5 percent (OECD 2005).

[15] The use of cost-benefit analysis signals progress in the management of governments. However, in most cases, it does not rely on market prices and is therefore more akin to guesswork than to economic calculation.

Core government spending and government transfers of all kinds do not and cannot rely on the profit-and-loss guide that entrepreneurs use in the discovery process.

It is true that the New Zealand government owns commercial entities (state-owned enterprises). However, it is not clear what would happen if they were to experience losses. The government might bail out the enterprises it owns more readily than it bails out loss-making private companies.

Most government spending weakens the general entrepreneurial discovery process because it consumes resources that entrepreneurs could have used to create value. It is impossible for the government to appropriate a large proportion of the economy's resources and, at the same time, foster high levels of productive entrepreneurship.

The burden of New Zealand's current levels of government expenditure could be diminished by freezing real expenditure per capita. If held at 2004 levels, government spending could be down to 26.7 percent of GDP by 2008/2009 (Wilkinson 2005). The adoption of constitutional constraints on government spending might help achieve such a result.[16] Freezing government spending would force harder choices to be made where programmes are not achieving desired results. This might lead, for example, to a reduction in welfare expenditure. Total expenditure on social welfare as a proportion of national income has increased since the beginning of the reform process.[17] Government transfers constitute one of the biggest items in the budget. The incentives for low-income individuals to receive welfare benefits instead of working are considerable. Freezing government expenditures would also encourage the government to sell some of its assets (for example, its shareholdings in state-owned enterprises) to fund other capital spending or reduce debt. Finally, it would limit public choice problems: with less money being spent, interest groups have less incentive to dedicate resources to rent seeking.

Rather than cut spending, however, the 2005 Budget included significant additional spending to promote increased opportunities, particularly through education; to enhance security through health spending, additional police staff, a long-term defence spending plan, funding for Working for Families and the Rates Rebates Scheme; and to support economic growth (New Zealand Treasury 2005a). These large increases in spending help to explain the deteriorating growth forecasts for the years up to 2009. Instead of freezing real per capita expenditures, the Labour-led government has chosen to increase them, which will only cause further damage to the entrepreneurial environment.

[16] See Wilkinson 2004, sections 4 and 5, for a discussion of mechanisms to limit government spending; see also section 3.5 for a discussion of the problem of poor quality core government spending. Wilkinson concludes that 20 percent of GDP would be enough to finance core public good roles and a safety net.

[17] See Kasper 2002 and Brash 2001. Brash regards transfer payments as a major burden on the New Zealand economy. While the recorded increase in welfare spending is artificially inflated by policies such as grossing up benefit payments that were made taxable in the hands of recipients, those policies do not account for the bulk of the increase in welfare spending.

Taxation

The design principle of the New Zealand tax system – broad-base, low-rate taxation – is desirable insofar as low rates compensate for the broader base. If rates are not lowered enough and the base is expanded, average tax rates remain high. The incentive to engage in market activities (as opposed to non-market activities) has increased because marginal rates have fallen and the broadening of the base has reduced the scope for untaxed activity. As Davidson puts it, “Unlike the situation in many countries, New Zealand’s income tax base is relatively broad and provides limited scope for taxpayers to avoid the top tax rate” (2005, 3). (Individuals on upper incomes can use trusts to shelter income at a lower marginal rate: trusts are taxed at 33 percent, whereas the top rate on individual income is now 39 percent.)

The broadening of the tax base can be illusory. It is not true that consumption can be taxed independently from income. Ultimately, there is only one tax base: the income realised through exchange. Simultaneous taxation of any other base is double taxation. This fact has been recognised to some extent in New Zealand – for example, by the abolition of death duties. However, income tax, GST and excises all derive in the final analysis from the same base, even if they offer different opportunities for avoidance.

The design of the tax base throws up many problems, such as whether capital gains and imputed rental income in owner-occupied housing should be taxed. Other considerations – such as compliance costs, political feasibility (for example, consequences for income distribution) and fluctuations of tax revenues – are often taken into account in tax design. Although using monetary income and consumption as the tax base may make sense, doing so creates multiple layers of taxation and therefore increases the tax burden.

The overall impact of the New Zealand tax reforms on the entrepreneurial environment has been positive. Average and marginal tax rates, however, are still high, and this affects the entrepreneurial discovery process.[18] Between 1985 and 2003, the total burden of taxation relative to GDP per capita increased by 3.6 percentage points, rising from 31.3 to 34.9 percent. In comparison, the burden of taxation in Ireland declined from 35 percent to 29.7 percent.[19]

The complex effects of taxation in practice can be seen by examining corporate taxation in Ireland. In 1980, the Finance Act introduced tax relief for manufacturers, which established an effective rate of corporate tax of 10 percent for selected industries. The category *manufacturing* was extended in 1987 to include financial services, shipping,

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[18] This fact is reflected in the Heritage Foundation/*Wall Street Journal* 2005 Index of Economic Freedom. New Zealand scores 4 out of 5 (best being 1) in the ‘fiscal burden of government’ category (Miles, Feulner and O’Grady 2005).

[19] See OECD Revenue Statistics 1965–2004 (OECD 2005). However, comparing figures for taxes as a percentage of GDP across countries is difficult. Differences in tax systems may not be accounted for in tax revenue figures. For example, one country may raise revenue that is spent on programmes that assist families in employment whereas another may assist such families through tax credits.

films and other sectors. The regular corporate tax rate in Ireland was 45 percent in 1980 and was increased to 50 percent in 1982. From 1988 onward, it was reduced, finally reaching 12.5 percent in 2003 when the 10 percent rate was eliminated (Martyn and Reck 2004, 50). In practice, the extent of the manufacturing sector was not always clearly defined. Given the difference between the regular corporate tax rate and the manufacturing rate, a large number of tax-arbitrage structures were created to reduce the effective tax rates of corporations.

Small, open economies depend to a greater extent than big countries on foreign direct investment. The tax treatment of that investment is important to capital markets. The low rates of taxation on foreign investment in Ireland have been an important factor in its economic success.

The New Zealand government's 2005 Budget included a few changes to taxation – in particular, small tax cuts to encourage investment and savings and to assist small businesses. Tax thresholds are to be increased to recognise fiscal drag due to inflation. A new work-based savings scheme, KiwiSaver, the rationale for which is dubious, will also be created. These tax changes will not significantly reduce the overall burden of taxation, however, and therefore are likely to have little positive impact on entrepreneurial activity.

The openness of the economy

Only in the past 20 years has New Zealand begun to open its borders fully to trade. The effects of more open borders take time to materialise because entrepreneurs often rely on their knowledge of local market conditions. As the economy opens up, trade with more distant markets becomes possible, but the accumulation of knowledge about foreign market conditions requires time. Modern information technology reduces that lag time but does not eliminate it.

Time is also needed for foreign market participants to realise the extent of the changes in a country and their effects on the quality of the country's products. In the 1950s, Japan and Taiwan were considered places that made cheap, low-quality products. Thirty years later, opinions of their goods had improved because the two countries had become a source of high-quality and high-tech products. Likewise, New Zealand's image as little more than an exporter of butter, lamb and wool has dramatically changed since the early 1980s. This change will probably continue and accelerate over the next decade or two.

This factor also relates to the issue of size. Although openness can compensate for the small size of its economy, New Zealand does not have access to a common market of 300 million people as Ireland does. Foreign tariffs erected against New Zealand products hurt the New Zealand economy, reducing the size of the market available to its producers and damaging the entrepreneurial environment. For example, the United States taxes New Zealand lamb and cheese heavily. Because of the barriers to trade posed by foreign tariffs, New Zealand is not in a situation like Ireland with regard to market size. In this respect, New Zealand would benefit from joining the free-trade agreement between the United States and Australia, provided it allowed for free trade

in agricultural goods. Doing so would open the door to the North American trade zone, which comprises more than 300 million people.

In the 1950s, some 40,000 people emigrated every year from Ireland.[20] In 2004, the flow was reversed: more than 30,000 people immigrated to Ireland (Ireland Central Statistics Office 2004). This recent influx is both a consequence and a cause of the economic change. Individuals also decide to stay in Ireland because they see the increased quality of life that can be obtained. The net population inflow generates a cumulative process in which more people entering the country expand internal markets and the community of entrepreneurs, thereby enhancing the division of labour and knowledge necessary for effective capital accumulation.

The same process is occurring in New Zealand, where the 'brain drain' has been arrested, at least temporarily. The 1990s saw a return to net population gains from immigration, due to increased arrivals and reduced departures.[21] New Zealand had become a better place to live, and net positive long-term inward migration is one result of that improvement. The virtuous cycle of immigration helps to improve New Zealand's economy by expanding internal markets and the community of entrepreneurs. It has been said that Ireland has benefited from its links to the United States forged by the Irish diaspora. Although New Zealand may not be in a similar situation, New Zealanders have more international connections today than they had 20 years ago. The world in effect has become a smaller place, and people have better knowledge of foreign markets, which helps entrepreneurs build the bridges they need to distant markets and slowly increases New Zealand's integration with the rest of the world.

Free trade in goods is a substitute for free migration. New Zealand has traditionally been a country of immigration based on unrestricted immigration from the United Kingdom and Ireland (until 1974), the free movement of residents between Australia and New Zealand, and free entry for those Pacific peoples who are regarded as New Zealand citizens. However, trade in goods was heavily restricted. The economic reforms dramatically changed this situation and today New Zealand embraces free trade more completely than most OECD countries. For now, however, the path to complete free trade remains obstructed (especially by foreign tariffs imposed on New Zealand products), which reduces entrepreneurial activity, job creation and economic performance.

The regulatory framework

The overall regulatory environment in New Zealand has dramatically improved since the mid-1980s. The World Bank Doing Business Indicator (World Bank 2005) ranked New Zealand number one in 2005. The enforcement of property rights is satisfactory, the level of corruption is negligible, and the costs associated with setting up a business

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[20] Net annual emigration from Ireland averaged 39,000 per year from 1951 to 1956 and 42,000 per year from 1956 to 1961 (Redmond 2000, 14).

[21] See Statistics New Zealand (2005) key demographic indicators and Glass 2004.

are low.[22] However, the World Bank study focuses on a limited range of indicators and largely omits major regulatory interventions such as the Resource Management Act 1991 and those affecting network industries. Over-regulation remains a problem in New Zealand and has got worse in recent years.

Thus, while the labour market has become much more flexible following the enactment of the Employment Contracts Act in 1991, the Act contained restrictions on contractual freedoms, which worsened over time. In particular:

- No contract that requires any person to be a member, not to be a member, or to leave a union was permitted.
- No one could contract out of a provision of the Act.
- The Act's mandatory personal grievances provisions were especially rigid in the case of unjustifiable dismissals: employment at will was abolished in New Zealand in 1991, although it accounted for a significant portion of all labour contracts until then.[23]
- Disputes with regard to employment contracts had to be settled in the Employment Court, a special court for labour disputes. Over the years, this court partially undermined the intentions of the framers of the Act by emphasising procedural correctness and 'fairness' in dismissals.

The Labour-led government elected in 1999 repealed the Employment Contracts Act and replaced it with the Employment Relations Act, which came into effect in October 2000. The Act introduced 'good faith' bargaining, the promotion of mediation over litigation, and the union monopoly on collective bargaining. Overall, it promotes collective bargaining by various means, such as the requirement that employers give union representatives information and workplace access.

In its second term the Labour-led government made more changes to the Employment Relations Act. These came into effect in December 2004 and further restrict the ability of entrepreneurs to contract for labour services. The amendments confer additional privileges on unions and create a bias in favour of collective bargaining and multi-employer collective agreements.[24]

So far these changes have not had significant impacts on employment. The unemployment rate in New Zealand stood at 3.6 percent in December 2005, and labour market participation was nearly 68 percent. New Zealand has a rate of job creation and destruction twice as high as that of most European countries.

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[22] World Bank Doing Business Indicator (World Bank 2005), the Corruption Perceptions Index (Transparency International 2004), and KPMG 2003; see also Djankov *et al* 2002.

[23] Employment at will is the employer's ability to hire and dismiss without showing a cause, along with the employee's ability to quit without justifying their action (unless otherwise stipulated in the contract).

[24] Many other regulations affect labour contracts, including health and safety requirements, discrimination (regulated by the Human Rights Act 1993), minimum wages, legally mandated holidays, the state monopoly in accident insurance (opened to competition in 1998, then renationalised in 2000), and taxpayer-funded paid parental leave.

However, the recent employment law changes have worsened the entrepreneurial environment, as reflected in the latest Fraser Institute's *Economic Freedom of the World* index where New Zealand received a score of only 5.9 for labour regulation, relative to 10, the best possible score (Gwartney and Lawson 2005).

New Zealand's regulation of utilities, especially electricity, gas and, increasingly, telecommunications, is ill-conceived and excessive. The government is now going back to a more regulated environment, adopting forms of utility regulation that other OECD countries have used. These include establishing dedicated policy watchdogs, a role the Commerce Commission is now undertaking. The utilities reform of the 1990s was based on the idea that utilities were similar to other businesses and should be left to operate in the market, subject only to light-handed regulation. However, outdated views of monopoly and market power have influenced the reform process in ways that have not permitted the market to operate effectively. The privatisation and deregulation of utilities in New Zealand is incomplete and is now going backward, with the Labour-led government reintroducing the visible hand of regulation.

The government has established or resumed ownership of several commercial enterprises, such as Kiwibank, Air New Zealand and the rail track network. Although these enterprises face commercial incentives, their cost of capital is artificially reduced, creating market distortions. Taxpayers' money would be better invested by the taxpayers themselves. Instead, state-owned enterprises that should be moved immediately to the private sector still await privatisation.

Other important regulations have changed in a way that is unfriendly to the entrepreneurial environment. Examples include takeover regulation, the Commerce Act 1986, industrial policy (for example, the government's Growth and Innovation Framework) and ratification of the Kyoto Protocol on climate change. Although the major costs of doing business are still relatively low, they are higher than they need to be and the trend now is toward further regulation.[25] New Zealand should strive to keep its regulation light-handed in accordance with the principles of the 1980s reforms. Any other approach contributes to the growth of government and thus is detrimental to the entrepreneurial environment.[26]

Unfinished business

A recent survey shows New Zealanders' attitudes toward business and the economy to be reasonably positive.[27] New Zealanders are interested in a good quality of life, have ambition and motivation in their personal lives, and favour business and economic growth. Like most other people, they are interested in bettering their lives. After years of reform, most also understand that to create wealth one needs a culture

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25 See Tyler Cowen's web log of 8 July 2004: 'Is New Zealand Backsliding?'.

26 See Wilkinson 2001, especially chapter 8, on ways of constraining government regulation.

27 See New Zealand Growth and Innovation Advisory Board 2004, a government-sponsored report, as well as Kerr 2005b.

that favours work over welfare and the market system over government dirigisme. This cultural attitude is important to the future of the economy because it may help people resist the temptation of further intervention if economic conditions deteriorate.

Nevertheless, the reform process has stalled since the early 1990s and, to a large extent, New Zealand has lost its bearings: the consistent reform of the 1984–88 and 1990–91 periods has given way to a stop-start, zigzag reform effort (Kasper 2002). Among other things, the Labour-led government sees more interventionist policies as a way to improve economic performance (Clark 2002). The founding of the economic development agency New Zealand Trade and Enterprise manifests this view. Some in power still see picking winners and conducting an active industrial policy, such as promoting clustering and awarding grants to businesses, as a route to prosperity.

Governments around the world have used such policies with little success. The example of Ireland is often cited as a case in which grants from European Union (EU) structural funds have made a difference. In reality, Ireland's economic growth owed little to EU transfers. Net EU receipts and Irish growth rates have moved in opposite directions, and the high growth of the late 1990s occurred as EU transfers were phased out.[28] European Union transfers have not contributed to improvement of the entrepreneurial environment in Ireland, which is what ultimately matters. Similarly, New Zealand's recent active industrial policy has not contributed to improvement of the entrepreneurial environment. Quite the opposite: it has led to the deterioration of that environment by creating rents that entrepreneurs seek, and by disturbing market signals.

Another issue emerging since the mid-1990s is the impact of the electoral system. The Electoral Act of 1993 introduced proportional representation – in the form of the German-style mixed member proportional system (MMP), replacing the first-past-the-post (FPP) system.[29] The first election under MMP was held in October 1996. Since then, every government has been formed as a coalition of various parties. No electoral system is perfect, to be sure, yet MMP, by fostering coalition governments, can stifle the capacity for reform. The reforms of the 1984–91 period were possible in part because of the FPP system and the unicameral legislature. Moreover, various studies have shown that public spending is higher under proportional representation than under the FPP system.[30] The existence of coalition governments helps to explain the modest growth New Zealand has experienced since 1996, and is likely to stifle more reforms in the future.

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28 See Powell 2003. See also Powell 2004 for an analysis of the role of industrial policy among the East Asian tigers, and Desrochers and Sautet 2004 for an analysis of clustering policies.

29 Under the FPP system, the candidate with more votes than any other single candidate in a particular electorate is elected. An argument of proponents of MMP was that FPP tends to foster a two-party system and delivers majority governments, thus ignoring third parties even when they achieve a significant level of support.

30 On the impact of electoral rules on fiscal policy, see Persson and Tabellini 2004.

The Labour government has made growth a top priority, but this commitment has not been translated into policies for improved economic performance. Governments cannot engineer growth; they can only create the environment in which entrepreneurial activity takes place. By improving the institutional environment, government indirectly steers entrepreneurship toward productive and socially beneficial activities (Boettke and Coyne 2003; Sautet 2005).

The New Zealand government should now focus on four major policies to improve entrepreneurial incentives:

1. Reduce the size of government by freezing its real per capita spending. Although the structure and quality of government spending have improved, the magnitude of that spending relative to GDP has remained almost unchanged since the period preceding the reforms.[31]
2. Improve the efficiency of the tax system by reducing high marginal rates of tax. Taxation affects entrepreneurial incentives by reducing the size of profit opportunities.
3. Continue opening the economy because entrepreneurship, leading to the division of labour and specialisation, is enhanced by expanding markets.
4. Improve the regulatory environment, which in some cases is becoming worse.

These four types of measures would further improve the entrepreneurial environment and, over time, raise the prospects for economic growth.

Conclusion

Modest growth in New Zealand is not the result of an overdose of reforms or bad cultural attitudes. Much progress has been made since the 1980s, as recent statistics on productivity released by Statistics New Zealand have confirmed. However, more remains to be done if Kiwis are to become tigers. In short, the reform process has not been completed, and needs to be extended. As Martin Wolf put it in the *Financial Times* in November 2004, "It is simply wrong to describe [the] reforms as delivering a *laissez-faire* paradise. The end point is, rather, a reasonably deregulated, competitive market economy, with prudent fiscal and monetary policies and a better-run government". A "reasonably deregulated, competitive market economy", however, is not enough to generate a high rate of growth in income per capita. The only way to better economic performance is to create a better entrepreneurial environment. Only by guaranteeing the free emergence, discovery and exploitation of profit opportunities can countries improve their growth prospects over time.

The reforms have delivered substantial results, considering the point of departure, but New Zealand has not become a growth dynamo like Ireland because the reforms

[31] Moreover, the quality of many policies, especially in health and education, has stagnated in the past 10 years. A great deal of money has been spent to little effect.

implemented did not go beyond OECD standard practice. To become tigers, Kiwis must adopt more radical reforms. Unfortunately, the Labour-led government in its 2005 Budget (and in its new incarnation after the September 2005 election) shows little inclination to improve the institutional environment in which entrepreneurial activity takes place. Rather, it prefers to continue increasing the size of government and, through regulation, to tinker at the margin with the rules of the economic game. In the absence of changes, New Zealand's economic outlook seems likely to be mediocre rather than exciting.

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