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**BEYOND THE SOUND AND FURY:
GOVERNMENT POLICY, CORPORATE
GOVERNANCE AND ECONOMIC
PERFORMANCE**

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BEYOND THE SOUND AND FURY: GOVERNMENT POLICY, CORPORATE GOVERNANCE AND ECONOMIC PERFORMANCE

I want to take this opportunity to reflect on the respective roles of public policies and business management in national economic performance. Both are vitally important, and there are links between them. But a country is not a company, and economic expertise and the quality of economic management are very different from commercial expertise and the quality of business management. We need to understand the distinctions if we are to avoid muddled thinking.

Modern scholarship into why some countries prosper and others don't goes back over 200 years, but contemporary evidence continues to reinforce its findings. A key lesson is that policies and institutions – such as property rights and the rule of law – matter. The Business Roundtable directs most of its efforts to public policies. Organisations like the Institute of Management and the Institute of Directors specialise in management and governance. These are complementary roles.

An easy way to understand the importance of public policies is to contrast the post-war experience of divided countries like East and West Germany or North and South Korea. There was nothing very different about the people or the industrial structures of these countries at the time they were partitioned, yet their subsequent economic fortunes diverged dramatically. In the 1950s West Germany was described as a free-market economic miracle and from the 1960s South Korea prospered with progressive economic liberalisation. By contrast, the government-dominated economies of East Germany and North Korea stagnated. Not only did material living standards suffer but individual freedoms were suppressed, privilege flourished and the environment was trashed.

More generally, as the world begins the twenty-first century it is clear that better economic performance is associated with greater economic freedom, and that in the

leading countries the liberalising trends of the past 20 years are continuing. Just one example: the share of government spending in national income has been falling for several years in most Organisation for Economic Development and Cooperation (OECD) countries – New Zealand is one of the few exceptions. Sounder monetary and fiscal policies, deregulation and privatisation have curbed inflation and helped raise productivity, and much of the world economy has been doing better than at any time since the 1950s and 1960s when similar policies were the norm. These trends in policy and performance have occurred under governments of all political persuasions and seem likely to continue.

In New Zealand, policies moved in a liberalising direction in the mid-1980s and early 1990s, and we saw similar improvements in economic performance. Despite criticisms of the reforms, few people today argue for budget deficits, high inflation, steeply progressive tax rates, industry protection, statutory monopolies or nationalised industries. But from the time of the 1993 election, reform efforts slowed to a crawl and governments ignored warnings that higher government spending would kill the goose that was laying the golden eggs. Recently policies have shifted in a higher spending and taxing, redistributive and more hands-on direction, contrary to ongoing trends elsewhere.

As the country's economic performance fell back from around 1996, despite temporary ups and downs, one set of debates has been about whether the wrong policies were put in place or whether the problem was that they were not maintained and extended. However, an alternative explanation, put forward, for example, by Brian Gaynor in the *New Zealand Herald* and by *Unlimited* magazine, places the blame on poor business performance – *Unlimited* refers to "our scandalous management". Proponents of this view, which I want to examine, focus on things like the quality of business management, corporate governance, weaknesses in commercial regulation, and the New Zealand sharemarket.

Economics training always makes me cautious about blaming people for systematically poor outcomes, whether a lack of value creation and innovation in business or chronic

underperformance in sectors such as health and education. Usually the problem in any dysfunctional sector is the incentives and constraints that people working in it face. It's hard to argue that the managers of businesses in East Germany and North Korea were genetically inferior to those in West Germany and South Korea. Indeed, what these examples suggest is that a good policy and institutional environment creates good managers, and that no amount of talent and effort can compensate for a bad environment.

Having said that, I think there is force to some of the criticisms of business performance. It would be surprising if it were otherwise. New Zealand had to negotiate a difficult transition from an inward-looking and protected business environment to an outward-looking and competitive one. The attributes for business success in old New Zealand were things like contacts with politicians, skills in getting around regulations or using them to advantage, tax planning, the ability to prosper from high inflation, and cunning in dealing with unions. By contrast, the new environment put a premium on skills in leadership, business strategy, meeting consumers' needs, financial management, employee relations, risk taking and innovation. Countries like the United States have had a deep reservoir of such business skills going back many decades, and a culture that values individual and business success. New Zealand lacked these attributes, which are not acquired quickly.

Thus it was regrettable but not surprising that in an environment of greater economic freedom in the 1980s, some so-called 'entrepreneurs' failed spectacularly, and it was inexcusable that others broke or pushed the limits of the law. But even here, a sense of perspective is necessary: in Australia, where the economy was also being opened up, there were many more spectacular failures and more cases of wrongdoing. Absent wrongdoing, accusations of greed should be directed more at those who put their money into high-risk investments than to those who solicited their funds. And we should not lose sight of the fact that, human nature being what it is, there will always be some poor managers and some rogues, and there will always be some failures, especially in downturns. Just look at the recent Nasdaq meltdown, and the hordes of disgruntled shareholders liberally casting blame around.

Similarly, in the 1990s much has been made of the amount of shareholder wealth that has been destroyed in the corporate sector in New Zealand. There is no doubt that there have been some egregious cases of poor management and poor corporate governance, but the numbers are not large. Again, a number of points need to be made to put the issue in perspective.

First, New Zealand hasn't had this problem to itself. ANZ Bank research puts the total losses between 1991 and 1999 at around \$14 billion. In Australia, BHP alone destroyed more than that amount of shareholder value in recent years, and several other big companies lost large amounts.

Secondly, a failure to cover the cost of capital is by no means confined to the listed company sector. ANZ's research of 500 private companies showed that in 1998 there was a combined loss of value of \$6.5 billion, and preliminary indications are that the loss for 1999 was of the same magnitude.

Thirdly, it is not appropriate to consider losses in shareholder wealth without also considering gains. According to Stern Stewart research, a large majority of companies (76 percent in 1998 and 80 percent in 1999) had created value. The largest losses in value have been very concentrated by firm and by sector.

Fourthly, in a competitive market shareholders can expect firms to earn, on average, no more than their cost of capital – that is to say, normal profits. Excess returns will be eroded by competitors, and negative returns will be eliminated by corrective action or firms exiting the industry. The benchmark for assessing performance should therefore be a zero change in value. Spectacular out-performance – as has been the case with a few New Zealand corporates – is no more probable than spectacular underperformance.

Finally, the effect on the economy overall of the large losses in value by a handful of New Zealand corporates is quite small. New Zealand is not an economy of big companies. The 50 or so member companies of the Business Roundtable probably

account for only around 10 percent of gross domestic product (GDP). The merger of BHP and Billiton will result in a company with a market capitalisation greater than the entire New Zealand sharemarket. Obviously underperformance by a small number of New Zealand corporates can only have a minor impact on economic growth.

I conclude from all this that the idea that poor business management has been a major factor in poor national economic performance is simply erroneous. Business journalists, trade union officials and others who make this claim are free to put their money where their mouth is and go into business to compete with existing firms or take them over if they think they can do a better job. Business is about risk-taking which involves profits *and* losses; the fact that losses occur is not an indictment of business or business people. An absence of losses would almost certainly mean too little risk taking and innovation was occurring.

None of this is to defend the major management and corporate governance failures that the critics rightly point to, or to express complacency. The relevant question, however, is what can be done about such problems.

The short answer is that there are not many positive things that policy can do to improve business management. Governments can create a competitive environment, they should put effort into upgrading formal education at all levels, and they should strive to make their economies attractive for talented people to work in. Moderate taxes are important here. Foreign investment should be welcomed since it brings with it new practices and management skills. But governments can't directly foster the skills of entrepreneurship and an entrepreneurial culture. Entrepreneurship is primarily a matter of learning by doing, and developing a deep reservoir of business skills takes a country a long time.

One issue that the New Zealand culture still finds it hard to come to terms with is high salaries for top business talent. I've learned from first hand experience on the boards of the Electricity Corporation in New Zealand and Colonial in Australia the phenomenal difference that a world-class chief executive makes. Roderick Deane and Peter Smedley

were worth their weight in gold to those companies. Top executives get paid large amounts not because they can dictate their own salary but because boards understand their value to shareholders and seek to recruit and retain them. The cost of even a large salary package is a tiny fraction of the total costs of a firm. Large Australian companies like Telstra, Westpac, Coles Myer, AMP and recently BHP have had to go to the United States for chief executives and pay US-type salaries – and not all of these initiatives have been successful. Average CEO packages in New Zealand are less than half of those in Australia and one-fifth of those in the United States. In an international market for highly mobile executive talent it seems highly unlikely that with such large pay differentials New Zealand will generally obtain top quality management teams. On the other hand, one of the consequences of the much-maligned branch economy trend is that New Zealand operations of overseas firms will benefit from management quality at the top of the parent companies.

Others have made the point that not only are New Zealand top executives badly paid; they are also paid badly. There seems to be a weak link between pay and performance. I have a good deal of sympathy with complaints that executive pay and increases in directors' fees in some New Zealand companies have borne no relationship to shareholder interests. Provided media commentators and shareholder activists appreciate the reality that high rewards are usually needed to acquire top talent, I applaud their efforts to hold companies accountable for shortcomings in performance.

I suggested that governments can't do a lot directly to improve business performance, but they can certainly make the job more difficult. Regulations that remove privacy of salary information expose top managers to envy and malice, reducing the attractiveness of envy-prone countries as places to work. They also have a ratchet effect on pay by making relativity comparisons easier. Regulations that make it difficult to fire non-performing executives except at great cost are damaging to shareholder interests. So too are restrictive takeover regulations that protect poorly performing boards and managements from the threat of takeover. Excessive statutory duties and liabilities imposed on directors foster defensive behaviour and a culture of compliance rather than performance. We have seen the introduction of ill-conceived regulations in all

these areas in recent years in New Zealand.

Much misinformed commentary has drawn links between alleged inadequacies in New Zealand management, New Zealand's overall growth performance, the performance of the New Zealand sharemarket, and sharemarket regulation. This heaps confusion upon confusion.

People point out, for example, that in 1994 the NZSE Top 40 Capital Index was around 2000, more or less at level pegging with the Australian All Ordinaries index. They go on to observe that our index is still around the 2000 mark whereas the All Ordinaries is around 3200, and suggest this is due to better market regulation in Australia.

This reasoning is absurd. In 1994 the Dow Jones Industrial Average index was around 3600 whereas it is around 10,000 today. The US sharemarket has vastly outperformed Australia's, yet no one would suggest the difference is due to different market regulation. (Moreover, any proper comparison should focus on gross returns – dividends plus capital appreciation. The NZSE Top 40 Gross Index has risen from around 2000 in 1994 to around 2600 today.)

Sharemarkets are driven by company earnings – or more precisely expected earnings – which in turn are powerfully related to national economic performance. The performance of the New Zealand sharemarket matched that of other sharemarkets in the early to mid-1990s when economic growth was strong, and fell away as our economic performance deteriorated. Likewise Japan's sharemarket is currently at a 16-year low – one third of its level in 1989 – reflecting that country's deep economic troubles. No one would seriously suggest that those running Japanese firms suddenly lost their skills – the prime factor is a decade of government mismanagement.

Arguments that New Zealand's market regulation is inadequate or out of line with that of other countries are wide of the mark. With respect to takeovers, for example, the recent Kirin and Montana transactions that caused so much sound and fury would have been entirely permissible in the United States, the world's leading securities market. The mandatory bid and equal price provisions of the takeovers code that the

government is introducing would not apply to similar transactions in the United States, or Japan either for that matter. No one has explained why a one-size-fits-all rule should be imposed on all companies, and why shareholders should be denied the freedom to determine their own rules. With a few exceptions, such as an editorial in the *National Business Review* and an article by John Roughan in the *Herald*, editorialists and reporters completely missed these basic points in the recent hysteria. Yet time and again leading academics and professionals have raised principled objections to more heavy-handed takeover regulation, and inquiries have pointed to problems of enforcement rather than the law. It remains to be seen whether there were shortcomings in enforcement in the Montana case.

There has also been much sound and fury over insider trading in New Zealand. However, all my business experience and the advice of experienced people whom I have consulted suggest that serious cases of insider trading are few and far between. Companies and sharebroking firms have meticulous procedures for avoidance of insider trading, mechanisms for detecting it and education programmes for staff. One New Zealand company chairman who has probably had more contact with offshore investors in recent years than any other confirmed to me that the issue has never been raised with him. In his words, the idea that tougher regulations on takeovers and insider trading and a more heavy-handed Commerce Act "will somehow vastly increase share prices is, unfortunately, a complete myth."

New Zealand's insider trading law is poorly conceived: it was a botched response to the 1987 sharemarket crash. Nevertheless, in this area as well, the main problem may be enforcement. The legislation provides for shareholder remedies. Having become sick and tired of columnists and others complaining about insider trading and doing nothing about it (apart from calling for more regulation), I joined in an insider trading action last year following a damning Securities Commission report. I have learned in the process that doing so is not onerous or costly. Regardless of the outcome of this and other cases, there is a need for better insider trading law focused on the central issue which is the misuse of company property. Unfortunately, this is not the focus of the government's current review.

In summary, I suggest that claims of inadequate market regulation and business misconduct have little foundation as explanations of poor sharemarket and national economic performance. Personal experience and survey evidence suggest that, overall, New Zealand scores well relative to other countries for transparency and integrity in business. Unsubstantiated claims of 'wild west' behaviour coming from politicians or others with an axe to grind are irresponsible, and business people and regulators should stand up and say so.

The quality of business management and New Zealand attitudes to business and entrepreneurial success are certainly relevant factors. However, business has been on a steep learning curve and many able managers and entrepreneurs are coming through. Governments cannot do a lot directly to accelerate this process, although they can remove obstacles to better corporate governance. Business people themselves must strive to improve management and corporate governance performance. With competitive capital markets and no barriers to entry into industries, there is only limited scope for sustained underperformance. The availability of managerial talent could become a more serious factor, however, if the present outflow of highly skilled people is not soon arrested.

I conclude that the most powerful factor affecting national economic performance is therefore the quality of the economic framework within which business operates. The late Mancur Olson, author of *The Rise and Decline of Nations*, wrote that the best thing a society can do to increase its prosperity is to "wise up" in respect of its policies and institutions. New Zealand has lost ground in this regard, and current directions are at variance with those of more successful countries. The government's more recent emphasis on economic growth and issues such as business compliance costs is welcome. The reality, however, is that many of its own measures such as the widening of the tax scale, the retention of tariffs, more complex employment law and increased regulation of electricity, telecommunications and takeovers have all increased business compliance costs. No credible overall economic strategy to achieve a better economic performance has yet been articulated.

Currently there are some bright spots in the economy, but also some persistent weaknesses as well as threats on the international horizon. In the year to 31 March 2001, economic growth is likely to come in at somewhere between 2 and 3 percent, well below the government's expectations of 3.7 percent in the 2000 Budget Policy Statement. Despite recent favourable conditions the outlook for the year to March 2002 is likely to be in a similar range, and again below the same estimate of 3.7 percent in the 2001 Budget Policy Statement. I would be surprised if the Treasury or the Reserve Bank believed New Zealand's sustainable growth rate is now higher than 2–3 percent with current policy settings. The idea that this constitutes "an extremely rosy picture for New Zealand", as Terry Hall suggested recently in *The Dominion*, is bizarre. It is a recipe for New Zealand continuing to lose ground relative to leading countries. Pointing this out is not always a popular occupation. However, those of us in business must continue to debate the central issue of economic policy directions if we want a better business environment and a better economic future for New Zealand.