

**Japan/New Zealand Business Council
23rd Joint Meeting**

**The Business Experience of Economic Reform in New
Zealand**

**Roger Kerr
EXECUTIVE DIRECTOR
NEW ZEALAND BUSINESS ROUNDTABLE**

**CHRISTCHURCH
17 OCTOBER 1996**

THE BUSINESS EXPERIENCE OF ECONOMIC REFORM IN NEW ZEALAND

Japan's post-war economic performance has inevitably loomed large in economic policy thinking in New Zealand. Its period of rapid economic growth, averaging 8 percent a year between 1950 and 1973 and 3 percent a year between 1973 and 1990, saw Japan become the world's second largest national economy.

New Zealanders could not help but admire a country which, on the basis of almost no natural resources, had lifted its average per capita income level to nearly NZ\$50,000 by 1994 compared with under NZ\$20,000 in New Zealand - only 40 percent of Japan's level. After all, at the very same time that Japan was recording these levels of achievement, our own culture of mediocrity was seeing us steadily lose ground on the rest of the world. From a starting position among the highest per capita income countries in 1950 - and far above Japan - New Zealand had dropped out of the top 20 by the 1980s. Many New Zealanders were vaguely aware that the 'she'll be right' attitude needed to change, but still clung emotionally to the old cultural habits.

There has also been much to admire in Japanese society that was lacking in New Zealand. The unashamed pursuit of excellence in the Japanese education system contrasted strongly with 'progressive' education fashions in our own state schools, in which competition came to be regarded as elitist. Japan's work and savings ethics were rightly seen as important factors in its success. And Japan had succeeded in making the rapid transition to an advanced industrial society with few signs of serious social dislocation.

Some argued that the economic performance of Japan and, later, the other successful East Asian countries was largely due to policies of active government intervention to guide investment and pick industry winners. But such a view cannot seriously be sustained and a host of studies over the last 15 years have largely disposed of it. Such interventions in Japan were less extensive than in many countries, not least New Zealand. If state planning and direction were the key to successful development, the countries of Latin America, Eastern Europe and sub-Saharan Africa would be among the world's economic leaders. Conversely, free-market Hong Kong, arguably the most successful Asian country of all, would never have prospered.

While devotees of the Japanese Ministry of International Trade and Industry (MITI) will tell stories about its successful picking of winners, there have been many occasions when the horses backed by MITI failed to come home at all, and when those passed over by the 'experts' went on to pay spectacular dividends. Nor is that surprising: bureaucrats and industry groups are poorly placed relative to individual entrepreneurs to identify production and market opportunities. Clearly if we want to understand Japanese economic success, we need to look at other factors.

One of these is the export orientation of Japanese industry which has made it responsive to the disciplines of world markets and to the uptake of new ideas and technologies. Japan is a relatively open economy: while it still maintains unnecessary trade barriers, overall it is more sinned against than sinning. Competition in many markets in Japan is fierce. Another factor has been the generally high quality of macroeconomic management. Japan's inflation record has been exceptionally good. Until foreign governments foolishly started applying pressure for 'stimulus' packages, Japan believed in sound public finances and did not subordinate the budget to efforts to manipulate economic activity. Even more importantly, the small size of the overall government sector has been a major factor in Japan's growth performance. The government expenditure burden on the private sector is much lower than in most western countries, providing stronger incentives to save and invest.

Not surprisingly, in overall terms Japan and the growing number of other successful East Asian countries rank highly in international comparisons of economic freedom - a factor found to be strongly correlated with economic growth. Hong Kong is in first place, Singapore third and Japan tenth in a recent study. Taiwan and even South Korea, at 16th and 20th respectively, rank well above the world average for economic freedom and their rankings have gone up since the 1970s. The success of Japanese and other East Asian economies is, overall, a story of substantial and increasing levels of economic freedom rather than one of government planning and direction, as it is so commonly misrepresented. As Nobel Laureate in economics Gary Becker has put it:

Japan earned its economic success the old-fashioned way, by combining a skilled, hard-working labour force with innovative companies that compete in a predominantly private enterprise system - not by pioneering a new type of capitalism.

Of course, a country's record of good government and economic success is always relative. There are many unsatisfactory features of Japanese economic policy, and some of them have come into sharper focus in recent years. Japan is no longer the 'miracle' economy of its earlier period of rapid economic growth, and shares many problems with other OECD countries. There are sectors that must be reformed if Japan is to regain its economic health. Ironically, some New Zealand commentators have periodically urged that we adopt these bad features of Japanese economic policy. Fortunately, over the past 12 years it has been the good features of the successful Japanese model, not the bad features, that we have increasingly come to apply.

We started - of course - from almost rock bottom. Prior to 1984 there was hardly a single area of New Zealand economic policy which could be termed even vaguely orthodox, liberal or outward-looking. Our industrial relations system was notorious for its inefficiency, inflexibility and adversarial nature. Macroeconomic policy was a shambles, and Keynesian demand management an article of faith. We had high personal tax rates, and a welfare state whose generosity was quite out of proportion to our ability to fund it. Capital markets were highly regulated. Anything that moved was licensed, and import protection was fortress-like. Most industries were chronically inefficient, and none more so than those that were delivering what we euphemistically called government 'services'.

Within their fortresses, businesses and industry groups spent much of their time lobbying the government for more privileges, and complaining that they could not possibly be expected to compete with anyone else. Protectionist attitudes abounded. By 1984 a growing number of people had realised that mushrooming debt, rising unemployment and stagnant living standards were all we could expect under such policies.

The subsequent economic liberalisation programme was grounded in the belief that it is private entrepreneurs - not governments - that create wealth, and that the economic role of any government is to set and enforce the basic rules which allow business to get on with its task of producing goods and services. In the restructuring programme, it was as crucial that industry be exposed to international competition as it was that domestic monopolies be deregulated. It was also important that a much more medium-term approach be applied to macroeconomic policy. Monetary policy ceased attempting to perform impossible and conflicting tasks - a role which had only exacerbated the instability of the business cycle. Instead, it settled down to concentrate on its legitimate medium-term role - controlling inflation.

Fiscal policy was aimed at restoring sound public finances: it stopped assuming that running deficits was the key to prosperity, or that somehow debt could be allowed to keep on growing. And in macroeconomic policy we not only achieved price stability and fiscal surpluses, we put in

place institutional mechanisms - the Reserve Bank of New Zealand Act 1989 and the Fiscal Responsibility Act 1994 - which provide us with a more stable, medium-term framework for macroeconomic management.

In the process of getting the deficit under control, limited progress was made in rationalising some aspects of the welfare state. But the overall cost of welfare is still a huge burden on the private sector. There are more people on welfare today than in 1984. The proportion of GDP spent on welfare has not shrunk, contrary to claims that the welfare state has been dismantled.

Perhaps our single most important economic reform was the abandonment of our centralised industrial relations system in favour of a regime closer to Japan's. I well remember Lee Kwan Yew being interviewed during a visit to New Zealand in the 1970s and explaining that Singapore had switched from a British-style, craft-based trade union system to labour arrangements on Japanese lines. "Japan," he said, "has got it right."

The phenomenal real wage growth in Japan and other East Asian countries - where labour markets today are typically lightly-regulated, lightly taxed and decentralised - was a living refutation of the sophism that strong monopoly union powers give workers the best deal. Two thirds of wage earners in Japan are taxed at effective marginal tax rates below 10.5 percent. Moreover, any observer not blinded by ideology could hardly fail to notice the very low rates of unemployment produced by East Asian labour markets. The Employment Contracts Act 1991 - which largely brought about free contracting in our labour market - has been a huge success. This is despite the active efforts to turn the clock back by some of our politicians and judges, whose failure to grasp how labour markets work has proved costly to workers and firms alike. They have still not absorbed the lessons from Asia, namely that competitive labour markets have yielded both rapidly growing incomes and remarkably even income distributions. Moreover, the combination of limited public welfare and high savings incentives have led to much popular capitalism and widespread accumulation of assets.

Needless to say, one of the most transforming aspects of our reforms has been the way in which the New Zealand economy has been opened up to international competition and international influences. The progressive lowering of import barriers concentrated the minds of our import-competing manufacturers: it forced them to raise their game domestically and find export markets. Corporatisation and privatisation have cut costs and improved the quality of service in former state trading departments. Financial market deregulation and the growing attraction of New Zealand as a destination for foreign direct investment have seen our economy become more closely linked with the rest of world, with all the expected benefits in terms of new technology, new ideas and new market linkages.

The results at the enterprise level have underpinned the much-improved growth performance of the economy. Manufactured exports have grown by an average of 8.6 percent a year since 1991 compared with 3.2 percent between 1985 and 1991. They account for 22 percent of sales in 1996 compared with 15 percent in 1985. Port costs in New Zealand have come down to below Japan's level and are well under half those of Australia. The price for a basket of telecommunications services has dropped by 50 percent for residential customers and 58 percent for business customers. Productivity in the main state-owned electricity generating company, as measured by gigawatt hours per employee, has more than doubled since 1987.

There has been a transformation in attitudes towards the global economy: businesses have become far more confident about competing in the world, and about moving to full free trade well within the APEC timetable. There has been a turnaround in the exodus of people from New Zealand: net immigration is now positive. This welcome development increases New Zealand's

stock of valuable human capital and knowledge, and further strengthens our economic ties with other nations. These are more important for a small, remote country than a large one. Many of our new immigrants are, of course, from Asia. With their skills, energy and positive attitudes, these newcomers can only benefit our economy. They can scarcely be blamed if their culture of achievement creates difficulties for some locals. On the contrary: their assumption that the world does not owe them a living is a refreshing injection of an ethic New Zealand badly needs, and which can only be a positive influence on our own complaining classes. The success of Asian children in school is also a spur to New Zealand students - who too often are content with simply getting by.

While New Zealanders can be proud of our reforms to date, we have no grounds whatsoever for feeling complacent. Many sectors are still underperforming, and we are only a middle-income country by OECD standards. There is much more we can learn about good government and private sector practice, and from the experience of countries such as Japan.

Education is clearly one area. Japanese teenagers lead the world on standardised tests of literacy, numeracy and scientific knowledge. This excellence does not result from a high level of inputs into the educational system: on the contrary, teacher salaries, per-pupil spending and teacher-student ratios are low by international standards. What does characterise Japanese education is a much larger role for the private sector. One third of all high school students, and a larger fraction in cities, attend private sector schools with government funding. Public and private schools compete with each other in Japan on a much more level playing field than in New Zealand, and private universities cater for almost 80 percent of the student population. So far there has been a strange reluctance in New Zealand to admit that more competition, choice and private provision would benefit the consumers of education just as surely as the deregulation of other industries benefited the consumers of their products. Even Japan seems to be in need of more diversity - there has been concern for some years about too much conformity and too little emphasis on creativity in its education system.

We can also learn from Japan that a large welfare state is in no way necessary for a cohesive society. The informal institutional strengths of the typical Asian family are an enormously important cultural asset. Japan's social structure is built on intact, sometimes even multigenerational, families. If a country without a New Zealand-style welfare state can achieve much lower poverty, unemployment, crime, drug abuse, family breakdown, and other negative social indicators, we should be prepared to revise some of our assumptions about the wisdom of our own arrangements.

With its ageing population and loss of its former dynamism, Japan too has real challenges to upgrade its economy in the years ahead. The latest World Competitiveness Yearbook still has Japan in fourth place, but comments that it is struggling. Japan is ranked only twenty-first for the quality of government, and the report highlights the need for political and economic reforms to deal with long-term structural problems. By contrast, New Zealand ranks third for the quality of government, but it has slipped from eighth to eleventh place overall this year. No doubt the fall is partly due to the fact that its reform programme has lost momentum in the last three years while other countries are working hard to improve their competitiveness.

The obvious strategy for both countries is to go down the path of further economic liberalisation. For instance, the absence of protection or subsidies for our farmers, and our much lower level of regulation in sectors such as retailing, can stand as an example to a country which needs to grasp those nettles. Our open capital markets and contestability of corporate governance also offer lessons for Japan, which has a level of capital productivity well below that of the United States, according to recent research by the McKinsey Global Institute.

The alternative scenario is that Japan loses ground relative to countries which are pressing on with liberalisation. Efforts at economic and administrative reform over the last three years appear to have been inconclusive. There are still plenty of people and groups in Japan wanting to adopt more interventionist policies. A recent visitor to New Zealand, Professor Haruo Shimada of Keio University, was outspoken about the way elements of the Japanese bureaucracy had elitist views of themselves, resisted efforts to reduce their control and were 'destroying' Japan. We all have an interest in Japan turning away from such habits and taking the path of further liberalisation.

In the past year I have been struck by the extent of Japanese interest in New Zealand's economic experience at the highest political level. Our organisation has been involved in discussions with Minister of State for Economic Planning Isamu Miyazaki and former Prime Minister Morihiro Hosokawa, and there have been many other visits. The political lessons that they would have picked up from New Zealand (and from other countries striving to make the transition to more open economies) are fairly clear.

One lesson is that reform is best achieved through a comprehensive programme, not by piecemeal initiatives. Gradualist strategies are ineffective and unfair, because the scope for vested interests to derail them is great, and the pain is not evenly spread and lasts longer. If the dog's tail has to be cut off, do it once not half a dozen times. Secondly, the longer the hard decisions are put off, the worse the problems become and the tougher the political management job. Thirdly, you can't achieve results without political leadership and courage, but the electorate will accept change if politicians explain clearly and openly why it is needed. There is now widespread support in New Zealand for the new economic directions, and whatever government emerges from last weekend's election, it will have no mandate to chart a different course.

I understand that much of the pressure today for reform of Japan's economy and bureaucracy is led by Japanese business interests. Such pressure and support is surely essential if reform-minded politicians are to be able to achieve necessary changes. In 'old' New Zealand, business was part of the problem and it had to become part of the solution. That may well be true in Japan also.

In our case, farming representatives and a small number of business leaders were the first in the private sector to recognise that New Zealand had to change direction. The initial experience of reform was very painful for many of those involved in industries such as farming and manufacturing. Numbers employed in manufacturing fell by 80,900 between 1985 and 1992 (but have since risen by 64,700 and will soon reach an all-time high). A number of member firms of the Business Roundtable did not survive. Nevertheless, we remained united in supporting the liberalisation policies of successive governments because we saw it as vital to New Zealand's future and to a healthy environment for business that the programme succeed.

Gradually the dynamics of lobbying in New Zealand changed. As industries became exposed to competition, they turned their attention to other sheltered sectors of the economy and urged governments to remove regulations which were adding to their costs. As restructuring proceeded, it became impossible to deny evidence of the gains from a more competitive environment and the arguments for maintaining regulatory privileges looked increasingly shallow.

Today virtually all business organisations are solidly behind the new economic framework. Business people have far fewer dealings with politicians and bureaucrats and can get on with the business of running their firms. Deregulation also had the benefit of reducing the risks of political corruption. Lobbying for government protection against competition has come to be

seen as bad form, and is now largely confined to one or two islands of the economy such as the agricultural marketing boards and the state accident insurance corporation.

Both our countries are now operating under new electoral systems with some features in common, one of which is that they are unlikely to throw up strong governments. In this environment, it is even more important that the business sector is prepared to give a lead to the rest of the community about the need for change and improvement if our countries are to cope with the challenges of today's global economy. Change is often uncomfortable, but social cohesion is not helped by economic stagnation and ever-rising levels of unemployment. The business community in New Zealand certainly believes much remains to be done to improve social conditions and reinstate New Zealand in the top rank of countries, and it will be supporting politicians who share that vision. It is to be hoped that Japanese business leaders will help the government which takes office after the coming election give a similar impetus to economic reform in Japan.