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**TE AWAMUTU CHAMBER OF COMMERCE
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**ECONOMIC REFORM AND THE FAIRNESS OF
'DO-IT-YOURSELF' ECONOMICS**

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ECONOMIC REFORM AND THE FAIRNESS OF 'DO-IT-YOURSELF' ECONOMICS

Economics suffers, like education, from the fact that everyone is an expert. Personal experience with part of the economy is assumed to be a qualification to talk about the wider picture. It is also very difficult to conduct controlled experiments in economic policy, which makes it a breeding ground for what David Henderson in his Reith lectures described as 'do-it-yourself' economics. This homespun branch of the discipline tends to be pessimistic about the value of markets. In place of economic analysis it substitutes vague and half-formed beliefs about things like strategic industries, national self-sufficiency and essential activities. It gives little consideration to the relative costs and benefits of policy decisions. A number of New Zealanders seem to be enthusiastic and vocal proponents of homemade economics.

Do-it-yourself economists tend to argue that the economic reforms of the past dozen or so years were unnecessary or, if necessary, that they were implemented badly, achieved little, and have been positively harmful to the poor. I want to deal today with each of these claims, especially the last.

A good example of people who make up their economics as they go along are two Massey University sociologists, Mike O'Brien and Chris Wilkes, who wrote a book in 1993 called *The Tragedy of the Market*. According to this book, it was a tragedy that successive governments since 1984 used market disciplines for pursuing economic and social objectives. Thus the book labels as a 'tragedy' the post-1984 policies which have successfully prevented New Zealand from growing poorer, while turning a Nelsonian eye to the earlier policies which saw us slip from being one of the richest countries in the world in 1951 to 33rd ranking in 1984. There is no mention of all the income forgone due to our

dismal performance over this period, and its effect on the poorest in our society. Needless to say, the book does not ask whether this fate might have been avoided had we imitated the factors responsible for the growth and prosperity of countries such as Hong Kong, Singapore and Taiwan.

Nor have the Massey sociologists examined the causes of the steadily increasing unemployment in New Zealand from the mid-sixties, or discussed why, when government expenditure has doubled as a percentage of GDP since social security was introduced, there remains a widespread perception that health and education services are actually declining in quality.

Moreover, if the move to competitive markets has been such a tragedy, you might assume the rest of the world would be moving away from market solutions towards government solutions. Yet nothing could be further from the truth. From conservative political parties to left-of-centre parties, from military regimes to communist countries, the last 15 years have seen a growing momentum to take governments out of things they do badly, such as running businesses, and to get them to concentrate on what they should do well. And where markets have been given the freest rein, as in some of the countries of East Asia, the gains in living standards to ordinary workers over the past generation have been enormous. These economies also have very low rates of unemployment, crime and family breakdown.

In New Zealand, all manner of indicators attest to the big improvement in economic performance as a result of our market-based reforms. Why are competitive markets proving so superior to the heavily regulated markets of old New Zealand? The answer is that there is a fundamental feature of markets that the Massey authors and the other do-it-yourself economists cannot or will not understand - the idea of mutual benefit through exchange. Market

transactions, from buying a loaf of bread at the local dairy to the purchase of an aircraft by Air New Zealand, depend upon buyers and sellers judging that they will be better off as a result. Since transactions are voluntary, they would clearly not take place unless that was the judgment of both parties. By contrast, the whole apparatus of government depends on politicians being prepared to use the coercive power of the state to tax individuals and spend their money, whether that represents value for taxpayers or not.

One of great advantages of an economy based on voluntary exchange is the way it uses information. Every time a voluntary transaction takes place, no matter how small, it produces up-to-date information on which decisions are based. When the price of a product rises because it is in short supply, there is a clear signal for users of it to economise and for producers to increase production. To be successful, a complex economy requires a strong flow of information, a capacity for rapid responses, and feedback on actions taken. In a market, each piece of information summarises an immense amount of data. And market prices not only satisfy the economy's need for information but also offer incentives to parties to change their behaviour. This is the feedback required to coordinate decision making.

The yawning gap in the commentaries of the market critics is that they propose no credible alternative mechanism. They keep on telling us there must be a 'better', 'middle' or 'alternative' way, although they haven't yet managed to come up with one. After this length of time we can be confident that they won't - that they will just remain in carping mode. All attempts to find alternatives to markets have failed because of information problems. In centrally planned systems, information turns out not only to be expensive to collect but also difficult to analyse and hard to disseminate. It is usually ignored when available. Prices bear little relationship to the costs of producing

goods and services, and decisions based on such prices result in queues, shortages and gross wastage.

Thus after several decades of peace, the Soviet-style economies in 1990 looked as though they had just emerged from a war. The goods they produced were of low quality, food shortages were acute, queues were long, environmental devastation was enormous, and social costs incalculable. Many enterprises were so inefficient they did not add value but subtracted it. The Soviet gross national product represented about a third of the value of the energy that was used to produce it.

Few do-it-yourself market critics will openly support the system of planning used in the ex-Soviet Union, but they still advocate a large government role in economic activity. And although different in degree from the Soviet planning systems, many government interventions fall into the same trap. Bureaucracies are designed to write laws and establish rules and regulations that set a framework for activities over long periods of time. Even when they consciously mirror private sector practices, they still have problems in responding to fast-changing situations. When government bureaucracies take charge of business activities or enterprises, the decision-making process has to slow down to cope with the timetable of the executive and parliament.

No wonder our economy has benefited from reforms which have relied on markets. By ceding its non-core roles to the private sector, the government can concentrate on its own very important and necessary core roles - including defining and enforcing a framework of rules and regulations within which economic activity can thrive. Prior to the reforms, the government's roles were conflicting and confused. Government departments often had commercial, policy and regulatory functions all in one agency, and one or more senior staff

frequently had responsibilities across all three. Where the government was the major player in a sector, the damage to private sector initiative could be fatal. Consider a potential investor contemplating a major forestry project. The investor knew that the people offering policy advice to the government were also regulating the project, providing technical services to the industry, and at the same time were the project's principal competitors. How many people would go ahead and make an investment under those circumstances?

Lack of accountability was a feature of this crazy system. As Michael Cullen has said in the context of the Reserve Bank Act, multiple objectives mean multiple excuses. There were consequently big gains when specialised institutions were created to undertake regulation, policy and commercial activities, and when many of the SOEs were privatised. In sectors such as energy, communications and transport, private and state-owned enterprises can concentrate on running successful businesses while policy makers can focus on the overall environment. So often we find that if a competitive market can be created, industry-specific regulation is unnecessary. State and private businesses, freed from political constraints, find cheaper and more effective ways of doing things to the lasting benefit of consumers.

The do-it-yourself economists are usually blind to these lessons. For instance, they will often acknowledge that unemployment is the biggest single cause of poverty, as well as a social evil in its own right. Yet they cannot bring themselves to admit that the big fall in unemployment since the implementation of the Employment Contracts Act demonstrates the benefits of labour market liberalisation. For the first time in many years the unemployment rate in New Zealand has fallen below that of Australia and most other OECD countries. But now the do-it-yourself economists' focus of concern has mysteriously shifted from unemployment. Instead there is a great

deal of breast-beating about what is alleged to have happened to wages and productivity growth under the Employment Contracts Act.

Our do-it-yourself economists are not even right about these claims. Average wages have not been falling, while recent productivity growth has been encouraging compared with our pre-reform history. The economic position of ordinary workers has been improving. The big improvement in the government's accounts as a result of the economic reforms has already delivered one round of tax cuts to low- and middle-income earners. There should have been another tax cut this year if the coalition government had not opted for an ill-conceived and massive spend-up, but at least it is due next year. And as the Treasury's 1996 post-election briefing makes plain, poverty has been falling in both absolute and relative terms in the 1990s. A big part of this improvement is due to the employment gains made possible by the Employment Contracts Act.

Indeed the removal of statutory barriers to employment helps workers far more than it helps employers. A large corporate may find, say, the minimum wage an irritant, but at the end of the day it will devise strategies to cope. A poor, low-skilled worker finds the minimum wage a barrier to getting a job at all. His or her life chances are seriously damaged. Any disadvantage to current employees from the loss of a regulated minimum wage is more than offset by the gains to new workers. And if there is a widespread problem of low market earnings among workers with dependents, governments can and do put in place policies of income support.

By contrast, labour market regulation typically serves the interests of people who are already employed at the expense of the unemployed, by protecting

them against competition from those with no work. The morality of such regulation is as shaky as its economic rationale.

Behind the do-it-yourself position on employment - particularly among unionists - primitive economic assumptions often lurk. Mike Moore reported recently that he was booed by a union audience when he told them the self-evident truth that their members' jobs were only secure when the companies for which they worked were earning a profit and not dependent upon government contracts, subsidies or protection. It is very hard to imagine how employers can offer people work if they are not profitable. State-owned companies, it is true, may not have this problem. An oil refinery in East Germany employed 48,000 people under the communist government. Restructured and profitable, it now has a workforce of 1,500. Imagine the task of finding things to keep people occupied on the previous scale. Imagine the cost of such padding across the whole economy. The only difference between the East German example and the former New Zealand railways and post office was the scale of the economic and human waste.

A few do-it-yourself critics still believe that returning to the previous regime of import protection would improve the climate for job creation. But protection and subsidies to one industry must be paid for by some other industry - one expands at the expense of the other. Activities that are only profitable because of assistance grow while those that can stand on their own feet are handicapped. Jobs are not increased but rather shuffled around into less productive activities, and employment growth overall suffers as the economy stagnates. The various measures that were used to protect New Zealand markets from competition in the past made this country steadily poorer, not richer. The higher cost structure was built into our real exchange rate: exporters faced not only increased domestic costs but lower returns from their

exports. This in turn reduced the wages they could pay, and the unsubsidised jobs they could offer.

Import licensing has ended and tariffs are being reduced, albeit too slowly. Nobody campaigns overtly for a return to import licensing, partly because its impact is so unevenly distributed between rich and poor. It was a mild inconvenience for wealthy people to be forced to delay purchases of clothes, cameras and electrical equipment until they travelled to Fiji or Singapore. The people most disadvantaged were low income people and others without the opportunity to travel. They had no escape from tariffs and the premiums attached to import licences. It is ironic that the self-appointed do-it-yourself spokespersons for the underprivileged often support measures even today that constitute discriminatory taxes on the poor.

The effect is the same whenever vested interest groups persuade governments to pass regulations restricting their competitors. The principal beneficiaries are the regulated producers and the biggest losers are the consumers with fewest choices. Retail price controls kept many inefficient shops going, and prevented the competition from large firms which has subsequently lowered margins, costs and prices. Price-regulated oil companies had a government-guaranteed rate of return on their inflated asset base. Now they have no such guarantee and have to work to compete for customers. Faced with fierce price competition and rapidly losing market share, Telecom had to cut its costs to stop losing customers. No regulator would ever have forced it to do that. It is the consumer of telephone services who has benefited from competition.

Deregulation almost invariably turns out to have advantages for those on lower incomes. A large number of New Zealanders have been taking advantage of the opportunity to buy second-hand Japanese cars. Despite the relatively high

mark-ups on the early imports, these cars were substantially cheaper than the second-hand cars on sale in New Zealand. More people entered the trade and the price of second-hand cars fell steadily, to the very great benefit of those who could only afford second-hand vehicles. One would think that the champions of those on low incomes would be leading the charge to support this trade or, better still, to get tariffs on new cars phased out. Not a bit of it. The leader of the Alliance once described imported second-hand vehicles as a waste of money and the party advocated tariff increases at the last election.

Some do-it-yourself economists believe that if business leaders support deregulation, this means it serves their own interests and not those of workers or consumers. Such a view is based on the absurd Marxist notion of social relations as a contest between classes, in which one group gains at the expense of another. In an economy based on mutual benefit through exchange, that picture is nonsense. All stand to gain from trade in open markets.

Businesses are by and large logical organisations. If the government sends out illogical signals, they will respond to them. Alan Gibbs tells the true story of the television sets which one of his former companies persuaded an Asian manufacturer to disassemble and ship to New Zealand so that the company could qualify for an import licence and reassemble them here. This madness 'created' two hundred or so make-believe jobs in New Zealand at the cost of doubling the price of every television set, thus reducing incomes and jobs elsewhere in the economy. Mr Gibbs supported the removal of import licensing and his company had to promptly abandon that business. The consumer was the beneficiary.

Another irony of the debate over import protection is its contrast with the arguments of the do-it-yourself economists on indirect tax. In the early days of

reform, much of their anger was directed at the introduction of GST and the cuts to personal income tax. Since GST is a flat percentage tax on nearly all expenditures, it was argued that it represented a much higher proportion of the total income of the poor than of the rich. In reality GST is a roughly proportional tax since most people spend most of what they earn over their lifetimes. Almost half of the revenue raised by GST was used to replace or reduce sales taxes and other indirect taxes. Also those on low incomes were compensated for GST by a package involving cuts to income tax and targeted income support. So the case against GST on equity grounds was never strong. What is noteworthy is that exactly the same criticism of GST could have been used by the do-it-yourself economists against high tariffs on imports: if GST is wickedly regressive, so are tariffs. But they never made that connection. That is one of the advantages of being one of this breed - consistency is not a requirement. The Alliance's proposal for an allegedly 'painless' alternative to GST, a financial transactions tax, is open to exactly the same criticism.

One of the purposes of lowering the top rates of income tax was to correct the perverse incentives that had been put in place through *ad hoc* tax changes over many years. By 1984 families on incomes not much above the average could be facing a marginal tax rate of 66 cents in the dollar. Meanwhile, tax deductions for investment in favoured sectors meant that many of the wealthiest people paid hardly any tax. The system was unfair as well as economically nonsensical, and represented the triumph of politics over rational policy.

A myth has lingered that the cuts to personal income tax and the introduction of GST were responsible for the widening of inequality in the late 1980s. But as the OECD and other commentators have pointed out, the main cause of that development was the big rise in unemployment at that time. This was due not to too much but to too little liberalisation - in this case to a heavily over-

regulated labour market which prevented new jobs being created at a rate which matched the job losses from restructuring. And there are no prizes for guessing who had been vigorously opposing labour market reform all along - the do-it-yourself economists.

At the end of the day there is no substitute for markets in liberating people from poverty, providing employment opportunities for all, and spreading the benefits of technological change to the widest extent possible. The people most helped by markets are the poor. If the do-it-yourself economists cannot accept that, it is because prejudice and dogma are substituted for anything resembling hard analysis. The rest of us just have to go on restating that analysis.