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MYTHS ABOUT ECONOMIC REFORM

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MYTHS ABOUT ECONOMIC REFORM

Earlier this year, the chairman of the Productivity Commission in Australia, Gary Banks, gave a talk about economic reform which contained striking parallels to many of the debates in New Zealand. The Productivity Commission is the Australian government's leading research agency on a wide range of economic policy issues, and its studies and reports (and those of its predecessor bodies, the Industries Assistance Commission and the Industry Commission) have influenced many of the economic reforms in Australia over the past 25 years.

Gary Banks began by saying that the history of economic reform in Australia indicated that worthwhile policy changes had rarely been easy to achieve. Reforms which were in the enduring interests of the community as a whole inevitably imposed adjustment costs on some of its members. They also threatened established privileges and perceived entitlements, some of long standing. Vocal opposition from those who benefited from the status quo, together with a more general fear of change itself, were powerful forces of resistance. As a result, Mr Banks said:

We face a critical juncture. Ironically, at a time when evidence of the pay-offs from past reform efforts is mounting – and when, as we grapple with the aftershocks of the Asian 'meltdown', the importance of securing a stronger and more flexible economy has never been more obvious – there is a mood to stop or turn back the clock, rather than build on our achievements. ... While resistance to change is understandable, the consequence of stopping or reversing reforms necessary to enhance Australia's productivity would be a progressive decline in the relative living standards of Australians. In a changing world, it is only by being adaptable and productive that Australians can achieve real security in their workplaces and regions.

The challenges to reform in Australia which Gary Banks listed include concerns about jobs and job security, the decline of services in rural areas and the perception that the reforms have meant 'all pain and no gain' for ordinary Australians. He argued that if nationally beneficial reforms were to proceed, these concerns and criticisms needed to be met head on. Compounding the problem were misunderstandings and myths about the nature of economic reform. Five myths

that he listed are worth discussing because they are often heard in New Zealand. Answering them is a task confronting all proponents of policy reforms worldwide.

Myth # 1 Stopping reform would ease pressures for change

It is often claimed that no more economic reform should take place because people are tired of change. Frequently there is confusion between changes genuinely associated with policy reforms and the many other changes that are happening all the time. For instance, changes in social attitudes are always occurring, which politicians have limited power to influence. The past generation has seen important changes in the roles of women. There are also demographic changes such as the ageing of our population. Many technological innovations bring major social change. The recent revolution in communications technology and computing is transforming workplaces. Like almost all technological advances since the beginning of the industrial revolution, the information revolution has on balance been beneficial. But it has also seen the demise of typing pools and routine clerical functions, and forced people to upgrade their skills.

Some countries have experienced a trend to a more unequal distribution of income in recent years. Critics of the market have been quick to blame economic liberalisation. Yet the evidence for these claims is typically sparse or non-existent. Studies have found that the major factor is technological change favouring skilled labour over unskilled. But there is nothing inevitable about this trend; technological change can have the opposite effect on income distribution. The innovations of the next generation could well favour unskilled labour over skilled. For instance, there might come a day when a computer programme can largely replace certain medical and legal procedures, yet constructing a robot that can satisfactorily perform housework still proves to be elusive.

Change is necessary if there is to be any progress at all. Most people want improvement in their lives, and improvement requires continuing change. Moreover, no government, simply through heavy regulation or control, can ensure that change occurs at some predetermined rate or that all bad effects can be avoided. By resisting many necessary changes prior to 1984 we built up a backlog of adjustment, and change was inevitably more traumatic when it happened. Change and risk will always be with us; it is a question of devising institutions that enable us to handle them well. Thus when New Zealand had a fixed exchange rate regime, uncertainty was not eliminated in the foreign exchange market. As the rate was pegged to a basket, individual currencies were volatile. Moreover, no pegged rate is fixed for ever, and under the previous system business people were faced with periodic, large devaluations that were difficult to anticipate and inevitably

disruptive. Those good at predicting the whims of politicians did well, while others were punished. The move to a freely floating exchange rate did not increase overall risks. Rather it made them more transparent and easier to manage.

Myth #2 Reformers have unlimited faith in 'the market'

This assertion merely sets up a straw man for easy demolition. Gordon McLauchlan is an example of a journalist willing to attribute quite absurd views to proponents of reform. In one of his many flights of fancy, he once wrote that I want New Zealanders to believe that "business not only brings us our dinner but our laughter, our love, our dreams, our soul's imaginings." Confronted with drivel of that sort, rational debate becomes impossible.

Economic reform does not involve slavish adherence to market forces. Competition, deregulation and privatisation are legitimate tools in the reform armoury, and they have yielded large benefits. But they are not ends in themselves and they are not relevant in all circumstances.

In reality, many limitations of the market are openly acknowledged by reformers. They understand the key role played by government in supporting markets through providing a sound legal framework. They also understand that the government must finance the provision of so-called public goods – those goods that would be under-supplied by the market. Hardly anybody would deny that the government has a role in public health, national defence or the policing of our streets, to name just three key public goods. No one wants a market for core police services.

The government also has an important role in maintaining a social safety net for those in genuine need. There is much to debate about the nature of that safety net – about its level, whether assistance should be in the form of cash transfers or of specific services, and who should be eligible to receive them. But the need for a state safety net of last resort – if the resources of personal savings and insurance, family support and help from the voluntary sector prove inadequate – is accepted by most people. Reformers are also aware that a market economy depends crucially on a wider civil society that is strong and supportive. Markets operate best when there is a culture of trust, honesty, respect for others, and good faith dealing. Such a culture cannot be created overnight by government, as reformers in Russia have discovered to their dismay. Where it is lacking, markets will be characterised by short-termism, fraud, fly-by-night operations and, at worst, gangster capitalism. Ultimately the

strength of our civil society depends, not on government, but on decisions made by all of us as individuals, and as members of the groups to which we belong. A market economy must be built from the bottom up.

Myth #3 Microeconomic reform is bean counting

Governments are always being accused of penny-pinching by some interest groups, as well as being criticised for using taxpayers' money extravagantly. We hear claims by public sector unions and others that education and health are 'under-resourced', despite very large increases in spending in these areas in recent years. Welfare spending is a higher fraction of national income today than it was in 1984. Experience suggests that the focus of attention should be less on the amounts spent and more on the poor performance of dysfunctional systems.

Many reforms within the New Zealand public sector – such as direct resourcing in schools or the separation of funding and provision in health – are aimed at getting better value for the taxpayer's dollar. Those in the social areas, however, have been partial in nature and only half-heartedly implemented, and it is not surprising that the community remains dissatisfied with these services. This represents a failure of political nerve as much as a lack of public policy understanding. It reflects the success of organisations like the PPTA and the Coalition for Public Health in clouding issues in the public mind.

Often good microeconomic reform has a positive impact on the government's budget, such as when subsidies to exporters were abolished in New Zealand. But sometimes it has had the opposite fiscal effect, as when tariffs have been cut. And it is easy to name existing New Zealand statutes where the purpose of the legislators would be better served by an explicit subsidy than by regulation. For instance, if the government were genuinely concerned about the employment prospects of people with disabilities, a direct subsidy to employers willing to hire them would achieve its objective far more effectively and transparently than the Human Rights Act – a statute that is wrongheaded and counterproductive because it denies freedom of association and contract in employment.

Usually the debates over microeconomic issues are not about limiting some total aggregate of money. More often they are about who is best placed to make decisions over how much money to spend. For instance, from the time of a 1987

report the Business Roundtable urged the abandonment of the government's ill-considered involvement in accident insurance. By creating an effective government monopoly, the architects of our accident compensation scheme ensured that accident insurance was inefficiently produced, and that consumer choice was seriously curtailed. The partial opening up of the scheme to competition already appears to be producing annual cost savings of the order of 30 percent for many employers. I don't know how much the average New Zealander would choose to spend on accident insurance if the government fully deregulated the market and ceased operating as an insurer. Nor does Murray McCully or anybody else. And that is my point: purchasing accident insurance is a decision better left to individuals and families than imposed by a one-size-fits-all government scheme.

None of this is to deny, of course, that the aggregate level of government spending is important. The Business Roundtable believes that government spending in New Zealand is currently far too high, and that the tax burden required to finance this spending is seriously hampering economic growth. If the government were limited to its proper role of financing public goods and a social safety net, spending could be brought down to below 20 percent of gross domestic product (GDP). Rather than taxing middle-income New Zealanders so steeply, and then returning their money in the form of 'free' but inefficient health and education services, it would be far more logical for the government to restrict subsidies for these services to the lowest income groups. Elimination of all the 'churning' in social spending would enable tax rates to be brought down substantially. So too would stricter reciprocal obligations on a number of welfare benefits.

Myth #4 Microeconomic reform is without social conscience

One popular claim is that reformers are only concerned about dollars and cents, not people. Ironically, proponents of this myth are often associated with organisations demanding quite explicit quantities of dollars and cents from the government, although they rarely spot the irony. Equally, they express concern about poverty, yet the key feature of poverty that they are usually concerned about is the lack of higher money incomes.

In a recent article, the Australian journalist and author Paul Kelly speaks of:

... the biggest and most dangerous myth in our current political dialogue – that economic efficiency leading to economic progress,

and social inclusion leading to a more caring and tolerant society, are incompatible. This assumption has almost become an article of faith in some quarters. The slogan is entrenched – if you believe in the market, you don't believe in society. It is damaging because it is false and its consequence is to weaken economic liberalism or social inclusion or both.

It is often forgotten that economics is a *social* science. Economic policy is all about people and their wants. And it is hard to see how delivering higher incomes to people ranks as an exercise without social conscience. Permanently higher incomes are achieved only through increasing productivity, which is what economic reforms are all about. Higher incomes enable people to consume more of those goods and services that are important to them. Such goods and services obviously include health, education, the arts, environmental goods, religious and charitable activities, and all those other activities that opponents of reform typically claim are neglected under economic liberalisation.

Moreover, societies can't share what they don't produce. By generating higher levels of national income, reforms aimed at improving the productivity of the economy provide the wherewithal to fund the access and equity objectives of governments in education, health and other key services. We do not see world class social services in poor, unproductive countries, no matter how 'free' to the consumer those goods may be. Even Ken Douglas, once a conspicuous client of the Soviet health system, has not been heard promoting it recently. Richer countries also typically have cleaner environments.

Myth #5 Reform has not delivered

This myth evaporates as soon as we compare the New Zealand economy in 1984 with today. Since a more coherent economic framework was put in place in the early 1990s, the economy has averaged around 3 percent annual growth and both independent and government forecasters expect growth of around 3 percent for New Zealand over the next few years. That is far better than we achieved in the decade to 1984. Over that period Sir Robert Muldoon borrowed his way into the history books. The economy was stagnant and living standards were artificially inflated by borrowed money. If Roger Douglas had not stepped in, the IMF would eventually have done so and with far more drastic medicine. The pain suffered by New Zealanders in some of the early years of reform was real enough. It was partly unavoidable and partly due to some key reforms being delayed far too long. But it

is incontestable that the economy is now stronger, and that the capacity of New Zealanders to increase their incomes over time has been boosted.

However, it is equally clear that New Zealand could be doing much better. Since the second 'wave' of reforms associated with Ruth Richardson's tenure as finance minister, there has been a step back for every step forward. In recent years a raft of badly-conceived initiatives have substantially increased government spending, especially the fiscal 'great leap backward' in the form of the \$5 billion of new spending in the National-New Zealand First coalition agreement (only reduced slightly in response to the Asian crisis). This has drained resources from the private sector, eliminated the budget surpluses, reduced national savings and contributed to a precarious balance of payments position.

Microeconomic reform has been similarly haphazard and intermittent. Consider producer board reform. Two years ago Lockwood Smith as minister of agriculture was ridiculing the Business Roundtable's arguments on this issue and instructing his officials to do no more work on it. Last year, after a budget announcement on reform promoted by New Zealand First, the prime minister pulled the rug out from under the feet of Lockwood Smith's successor, John Luxton, when the coalition broke up. Now Sir William Birch is heralding producer board reform as the government's major initiative in this parliamentary term, even though the proposals for the dairy industry fall well short of what would be best for the economy and export monopolies for kiwifruit and apples and pears are to stay in place indefinitely.

Similarly there have been some privatisations, but we are trailing well behind countries like Australia in sectors such as electricity which is crying out for private ownership as a means of rationalising the industry. Instead, price controls on electricity lines companies are promoted by the government – a shallow and short-term fix. To the astonishment of government officials, the prime minister told a recent local government conference that the government was abandoning its plans to lead reform of the water industry and was handing the job over to local government instead – the very sector that has been responsible for the industry's chronic underperformance. After the enormous advance of the Employment Contracts Act, the creeping re-regulation of the labour market by the Employment Court continues, and our unemployment rate remains a standing indictment of government policy. No wonder so many of the fundamentals of the New Zealand economy have deteriorated since the early 1990s. Surveys of international

competitiveness show us slipping down the world rankings at an embarrassing rate. Nobody except Winston Peters was surprised when our international credit rating was downgraded last year.

Numerous other myths about reform could be added to the list I have given. They would include the myth that, though the reform programme was needed initially, all the necessary changes have now been made. In areas such as privatisation, deregulation and the introduction of the private sector into infrastructure provision, other countries are making faster progress. Gary Banks remarked that when it comes to reforms to improve the performance of Australia's social infrastructure – its schools, hospitals and community services – Australia has hardly begun to scratch the surface, and the same could be said of New Zealand. Are we supposed to change the subject when anyone is obtuse enough to bring up our adult illiteracy statistics, or the hundreds of thousands of New Zealanders on welfare benefits. It takes an impressive suspension of the critical faculties to buy the line that no more reform is needed. Yet the government has not tackled the problems with any vigour, and many of the policies advocated by the opposition parties vary from the mildly harmful to the truly frightening.

In sum, while New Zealand has come a long way, there is too much at stake for us to become complacent or, worse, to attempt to turn back the clock. At present, political parties are clearly reacting to what they perceive to be elements of public opinion that want the world to stop or to revert to failed past policies. Gary Banks's comments indicate that the issues and debates are no different in Australia, and nor are they in other countries, but some are coping with them much better than we are.

I believe we are in this dilemma because governments from the early 1990s have failed to tell the public that New Zealand has much work to do to achieve its full potential. Neither they nor important parts of the media have been explaining that maintaining international competitiveness and raising living standards are processes that have no end. Organisations like the Business Roundtable that point out these realities are regarded as delivering a tiresome message. Many commercial and professional people are deciding that it is easier and more rewarding to do business elsewhere.

If New Zealand wants to avoid becoming another Tasmania with falling relative living standards and an outflow of its most talented people, it needs to wake up. Greater community understanding and acceptance of the need for continuous policy

improvement are pre-conditions for further progress. Allowing myths about economic reform to persist is a recipe for continuing paralysis. I hope I have made a contribution to dispelling some of them today.