

Policy Dialogue

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From the Brink of Bankruptcy The Transformation of New Zealand's Economy

The Right Honorable James B. Bolger, ONZ, New Zealand's Ambassador to the United States, delivered the keynote address at Pioneer's 2000 Better Government Competition Awards Dinner, outlining the market-based government policies he undertook as New Zealand's prime minister in the 1980s and '90s to rescue a country on the edge of economic collapse and help transform it into what is now one of the world's most robust economies. The following is an edited transcript of his remarks.



Former New Zealand Prime Minister James B. Bolger addressing attendees of the 2000 Better Government Competition Awards Dinner.

With governments commanding a significant slice—some would say a very large slice—of most modern economies, making government more efficient is a key ingredient to enhancing the performance of the entire economy. I don't think anybody can debate that. I would argue that countries should, when necessary, be encouraged to reform their economies.

The first point to observe is that transforming an economy is a dynamic process; in any transformation, you have to start with the world as you find it. The other point to remember is that transformation doesn't stop. There will be periods of time when change is more intense than others, but change doesn't stop. All economies continue to evolve, with the majority of change emanating from outside the sphere of government. So one period of intense transformation will in part sow the seeds of what will follow.

The New Zealand economy, following the arrival of Europeans, has been evolving for about 200 years, a somewhat shorter period than the United States, and with some 800 years of Maori history before the arrival of Europeans. One of the most intense periods of change took place in the final 15 years of the 20th century. So, I suggest we look first at how New Zealand got to the situation of the early 1980s.

New Zealand, like other countries, demonstrated in a very graphic way that excessive regulation and controls do not work. We had become one of the more poorly performing economies in the western world.

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Historical Background

One of the most significant events in New Zealand's economic history was the invention of refrigerated transportation in the 1880s. This paved the way for the transportation of sensitive commodities, mainly agricultural commodities—meat, dairy, produce, etc.—from New Zealand to Britain.

And that paved the way for a symbiotic relationship with Britain. We supplied Britain with food from our efficient farms and their investment capital laid the foundation for our economic development. Through war and peace, it provided a pretty good basis for prosperity, so that by the early 1950s, New Zealanders enjoyed the third highest standard of living in the world as measured by per capita gross domestic production (GDP).

Thirty years later—which is quite a short time—in the 1980s, our relative position in the world had slipped considerably. We were saddled with debt—technically on the verge of bankruptcy in the sense of almost running out of foreign exchange reserves. And government regulation was stifling the economy. Government regulations had reached the level at which wages, prices, the exchange rate, and interest rates were all controlled. New Zealand, like other countries, demonstrated in a very graphic way that excessive regulation and controls do not work. We had become one of the more poorly performing economies in the western world.

The seeds of decline were perhaps sown with the import substitution policies of the late 1930s. Quantitative restrictions and high tariff barriers were erected as a temporary measure. That's always dangerous in government. We once took personal tax rates up to 66 cents on the dollar as a temporary measure. But that temporary measure was in the face of balance of payments difficulties associated with the Great Depression. So you could see a cause and effect. Those temporary measures persisted for some 50 years in what the Heritage Foundation has termed a policy of insulation. With a tiny domestic market—even now we have less than four million people—we attempted to make most things ourselves, almost regardless of cost. And if we couldn't make it from scratch, we at times insisted on assembling it. At one stage—and this is truly remarkable—people were employed in overseas television plants to take assembled sets apart to then ship the parts to New Zealand, where they would be reassembled. We had expensive television sets.

This policy, of course, distorted investment flows, stifled innovation, and inflated costs across the whole economy. What it created was a hidden tax on the productive parts of the economy, and that became so high that by the late 1970s we had to begin to subsidize our most efficient sector, agriculture, just to keep farmers afloat. Farmers didn't want it, but they had to somehow survive. The insulationist mindset also meant that our most competitive industries

failed to adequately develop the international linkages that are vital for growth in a small economy. We were then, inevitably, poorly equipped to cope with the upheaval of Britain's entry into the European community in 1972, which was followed shortly thereafter by the economic shocks of the 1970s oil crisis. All of that compounded a poorly performing economy.

The point I would draw from this evolution is that it illustrates the adverse role that government can have—it can adversely affect the poor performance of the economy if it doesn't move soon enough or boldly enough.

Read Pioneer's 2000 Lovett C. Peters Lecture, "How Regulation and Taxation Stifle Entrepreneurship" by economist Walter Walters online at pioneerinstitute.org/research/dialogues/dia32.cfm.

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Steps Toward Economic Transformation

In the mid-1980s, faced with an economic crisis, the incoming government seized the moment to launch a far-reaching process of change. With government policy having played such a role in creating the situation that New Zealand faced, the bulk of the transformation process naturally focused on government action. The objective

was to provide a better basis for sustainable economic growth through setting a sound policy environment, reducing the role of government in commercial activities, and improving the delivery of core government functions.

Significant policy reforms were undertaken both at the macro and micro level. On the micro level, some of the earliest reforms were in the financial sector. Financial markets were deregulated; controls on prices, interest rates, and capital movements were removed; and the exchange rate was freely floated, and it still is. Many other sectors of the

domestic economy were also deregulated with the removal of government-imposed barriers in major infrastructure industries, such as transport, telecommunications, broadcasting, and electricity distribution. Labor markets were also substantially deregulated and decentralized.

With international linkages identified as integral to the success of a small economy, trade liberalization was one of the key areas of reform. All quantitative restrictions on imports were removed, all agricultural subsidies abolished, and tariffs significantly reduced. Today New Zealand has one of the most open economies in the Organization for Economic Cooperation and Development (OECD). Our average tariff is around 3.5 percent with over 95 percent of imports entering entirely duty free. New Zealand has also been active in seeking to secure better market access for our exports. We have comprehensive free trade agreements with Australia and most recently Singapore. And I committed along with others such as the United States to achieving free trade in the Asia Pacific region by 2010. We are active proponents of a multilateral liberalization under the World Trade Organization (WTO).

At the macro level, emphasis was put on creating certainty and providing a sound platform on which business could make investment decisions. The tax system was comprehensively reformed and simplified. Rates of direct taxation were significantly reduced, while a complicated array of indirect taxes was replaced by a single, value-added tax that applies across the board except for financial transactions and exports. A state duty was eliminated, and there is no capital gains tax.

Monetary policy was made completely independent of political influence, with the central bank being given the sole responsibility of maintaining price stability. The governor of the reserve bank is required as a condition of his employment contract to hold consumer price inflation to within a range of 0 to 3 percent.

Fiscal policy was also made subject to legislative discipline under what we call the Fiscal Responsibility Act. New Zealand governments are required to manage their finances and to present their accounts under the same disciplines as a prudent business manager. The act requires the government to disclose its true financial position, publish its spending and revenue intentions for three years ahead, and update those projections on a regular basis through the year.

In the mid-1980s, the government launched a far-reaching process of change: markets were deregulated, controls on prices removed, the tax system simplified, and monetary policy subjected to legislative discipline.

The website for the Organization for Economic Cooperation and Development is www.oecd.org.

The New Zealand government website is www.govt.nz.

Another key plank was reducing the role of government in commercial activities. Governments are typically not very good at running businesses, and New Zealand was no exception.

See “Lessons for Telecommunications Deregulation from the New Zealand Experience” by Maurice P. McTigue, who served in Amb. Bolger’s government as Minister of State Owned Enterprises and chaired the Cabinet’s Expenditure Control Committee, www.mercatus.org/policy/telecom_paper.html.

The act also requires governments to run budget surpluses sufficient to keep debt down at prudent levels. Government can always change the inflation target in the reserve bank governor’s contract or break the fiscal parameters they have signaled in advance. But the check on any reckless action is that in each case, there is transparency—the key component in our view in a modern economy. Such changes must be passed by Parliament so that voters know in advance of an election what the government is doing and why they are doing it.

Another key plank of the transformation process was reducing the role of government in commercial activities. Governments are typically not very good at running businesses, and New Zealand was no exception to that general rule. Before the reform agenda was implemented, the New Zealand government ran a lot of businesses. The largest bank was owned and run by the government, as was the only domestic airline, an international shipping line, the only railway system, all our electricity generation and distribution facilities, the dominant coal producer, the largest forest resource, and the only telecommunications company. Change has been considerable, as have been the benefits of that change. More than 20 former government enterprises valued at over \$13 billion were privatized in one of the largest privatization programs as a percentage of GDP in any country.

Many of these were bought in part or in whole by U.S. interests. The results were increased investment, improved quality of service, and sustainable profits rather than sustained losses. Entities such as the post office, which remained in government ownership, were put on a commercial footing, exposed to greater competition and competitive pressures, and now operate on private sector principles with an independent board. In fact, I think the New Zealand postal service is the only postal service in the world that was making so much money when it reorganized itself that it reduced the price of postage. Again, service levels have improved, and loss making has been replaced by dividends to the public account.

Minimizing Waste and Inefficiency in Core Public Services

Reform of the core public service was yet another major plank of the transformation process. Changes were designed to improve transparency and accountability in order to minimize waste and improve efficiency and service delivery. In most areas, service provision and regulatory management are now undertaken by different organizations. Ownership and management of state assets has also been separated, similar to a private sector governance model.

Government ministers represent the taxpayers’ ownership interests. And to make this clear, they contract annually with the chief executive of the relevant agency to purchase a specific set of services. The chief executive, who is employed under a fixed-term contract, is then personally accountable for meeting goals. Again, service has improved, and productivity levels have gone up.

One of the key advantages I saw come out of this was that ministers had to determine in a quite precise way what they wanted the department they had responsibility for to deliver. One couldn’t just go into the offices of a brand new minister and say, “Well, carry on as before. You know, this is a nice office and I’m pleased to be here, and I’ve got no bright ideas what you should do, so just keep going.” It would be unkind to say that ever happened before, but it could have. Now you have to sit

down and say, “This is what I want your department, Mr. Chief Executive, to deliver.” So it provides discipline in both directions—to the politicians and to the core public services.

A difficult area of reform is determining when and how to charge for services provided to the private sector. The difficulty is, given that services provided are part of the output of a large government agency, how is an appropriate charge determined for the service supplied? We’re still working our way through that, but certainly we have gone well past the free lunch stage. There is no particular reason why the taxpayers, if they’re providing a commercial service to a commercial entity, should do that for free. It should be charged at an appropriate rate.

The list of benefits is impressive: employment has increased, incomes have gone up, runaway inflation has been abolished, and government debt has been reduced.

These are some of the core elements of the process of transformation of the New Zealand economy during the last 15 years of the 20th century. There were many other aspects—including the area of social services—of what the OECD once described as the most comprehensive program of reform undertaken by a member economy.

The private sector also underwent a process of significant transformation, some of it induced by changes in government policy and the environment that those changes created for the business sector. Some commentators have criticized the results, and as with any process of significant change, there have been social costs, particularly for those with lower skill levels. But the overall list of benefits is impressive. Employment has increased. Unemployment has gone way down. Incomes have gone up. Runaway inflation has been abolished. Government debt has been reduced, with the surpluses projected to continue for the foreseeable future. And based on historical comparisons, the economy’s sustainable growth level has effectively doubled.

Into the 21st Century

As I said at the outset, the transformation of an economy is a continuous process. The policies of the ’80s and ’90s have created a more efficient and flexible economy. From this basis, the current government is now concentrating on taking New Zealand forward into the 21st century. It is looking at how best to provide conditions for innovation, new business creation, and investment, as New Zealand transforms itself into the knowledge-driven economy and society it needs to be in the future. This involves insuring our education system better delivers highly trained young people equipped with the skills for the knowledge economy, putting greater focus on resourcing and quality control of research and development, and attracting high-quality people and investments to make their home in New Zealand. There is now an opportunity in New Zealand to do things that were not possible before: it’s an excellent environment and an excellent platform on which to base business endeavors or to engage in partnership with New Zealand enterprises from the United States or vice versa. I’m pleased to report that there is a significant level of that happening.

Having successfully removed government’s negative influences from the economy, the focus is now on how government can best work in partnership with the private sector to promote growth in the new economy. I’m convinced that New Zealand society is very well positioned to gain maximum advantage from the transformation of the country’s economy.

For a look at a very different sort of government economic transformation, read “Transition From Communism: A Decade After,” the remarks of Václav Klaus, former Prime Minister of the Czech Republic, the speaker at Pioneer’s 1999 Lovett C. Peters Lecture in Public Policy, online at www.pioneerinstitute.org/research/dialogues/dia29.cfm.