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Free market reform in New Zealand: an Australian perspective

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The defeat of the Shipley National government in 1999 marked the end of a fifteen-year experiment in which New Zealand governments undertook some of the most radical free-market reforms ever attempted in a developed economy. Although some of these reforms produced the desired outcome, it is now clear that the reforms did not produce the results hoped for by their advocates. New Zealand's economic performance is particularly disappointing when compared to that of Australia, which faced broadly similar economic problems in the early 1980s and undertook similar, but significantly less radical, reforms.

The object of this paper is to assess the New Zealand reforms by contrasting the reform process and its outcomes with the Australian experience. A range of explanations for the failure of the New Zealand reforms to produce the anticipated results are considered and assessed.

Background

The political and economic history of Australia and New Zealand over the past twenty-five years displays both remarkable parallels, and important divergences. In 1972, both countries elected social democratic governments led by charismatic reformers, Gough Whitlam and Norman Kirk. By 1975, the collapse of the long postwar boom had led to the downfall of labour governments in Australia and New Zealand. Particularly in Australia, reaction against the failures of the governments of 1972–75 was a major factor in Labour's subsequent shift to the right. Subsequent Labour leaders were at pains to present themselves as responsible economic managers.

The governments that replaced those of Whitlam and Kirk were led by

conservative strongmen: Malcolm Fraser in Australia and Robert Muldoon in New Zealand. When they took office both men were seen as radical rightwingers, but from the vantage point of the 1990s, they are usually regarded as highly interventionist. This view is anachronistic, in that it projects policy concerns of the 1980s on to earlier periods, and misleading, in that the trend of policy under the Fraser and Muldoon governments was towards deregulation, even if hesitantly and with frequent reversals (Bollard and Buckle 1987).

The conservatives initially assumed that the economic crisis of the early 1970s would be resolved by a combination of monetarist macroeconomic policies and a cut in real wages. The second oil shock of 1979 made it clear that these assumptions were invalid, but provided a new hope, that of an export-led recovery based on minerals and energy. The most notable expression of this hope was Muldoon's 'Think Big' program, a set of projects based on the exploitation of natural gas and other natural resources.

By the early 1980s, it was clear that hopes for an export-led recovery were misplaced. The booms never eventuated and the projects designed to exploit them resulted in growth in international debt, particularly in New Zealand. The contrast between apparently boundless natural resources and poor economic performance created a widespread sense of disillusionment with the economic policies of the past. Rising unemployment and slow growth were seen as the outcome of national economic failings rather than as a part of an economic crisis common to all developed countries.

The steady decline in the terms of trade for exporters of primary products presented both countries with economic problems. Particular difficulties were created for New Zealand, which remained heavily reliant on British export markets over the postwar period and suffered economic losses when Britain entered the European Community in 1971. By the end of the 1970s, per capita income in New Zealand was between 5 and 10 per cent lower than in Australia.

It was against this background that labour governments were elected in Australia (1983) and New Zealand (1984). Although they had campaigned on fairly traditional social democratic platforms both of the incoming governments included influential supporters of the free-market ideas referred to in Australia as 'economic rationalism', and in New Zealand as 'Rogernomics' after its most prominent advocate, Sir Roger Douglas.

Douglas had expressed his discontent with existing policies in his book *There's got to be a better way* (Douglas 1980). By 1983, drawing on advice from businessmen and Treasury officials, Douglas had developed a radical free-market program, which he implemented once in office (Easton 1997a). The Australian Labor government was more cautious in its embrace of free-market ideas. Moreover the general dominance of economic rationalism was initially offset by the influence of the Prices and Incomes Accord, under which unions accepted wage restraint in return for various social initiatives, such as the reintroduction of a universal system of health insurance.

Parallel developments in the policy debate were unsurprising in view of the close links between the economies of Australia and New Zealand. Migration between Australia and New Zealand has never been significantly restricted and the Closer Economic Relations agreement signed in 1983 removed most barriers to the flow of goods. The parallel economic performance of the two countries up to the 1980s is therefore not surprising. The modest divergence in performance over the 1970s could reasonably be explained as a temporary shock, arising from New Zealand's greater reliance on the United Kingdom as an export market, and Australia's greater endowment of mineral resources, particularly coal and oil.

The surprise was the divergence that took place during the 1980s and 1990s when GDP per capita in New Zealand fell to a level 25 percent below that prevailing in Australia. Even more surprisingly, as Easton and Gerritsen (1996) observe, until the late 1990s, most international commentary was based on the assumption that

New Zealand's reforms had been highly successful, while Australia was seen to have suffered because of its less whole-hearted approach to free-market reform.

By the end of the 1990s, however, it was widely agreed that the New Zealand reforms had failed to produce the expected outcomes. The rapid economic growth of the early 1990s proved to be little more than a cyclical recovery from the 1989–1991 recession, and the renewed onset of recession in 1998 showed that reforms had not, as some had hoped, eliminated the ‘stop-go’ cycle of boom and bust.

The election in 1999 of a Labour government pledged to roll back some (though by no means all) of the free-market reforms marked the end of the era of radical free-market reform. It is, therefore, an appropriate time to consider why the New Zealand reforms failed to deliver the expected outcomes, and why New Zealand fell behind Australia in terms of income per capita.

The reforms in Australia and New Zealand

Australia and New Zealand faced similar policy problems, and the policy agendas put forward by advocates of free-market reforms in the two countries were very similar. However, differences in the policy process and the random effects of differences in personalities led to significant differences in policy outcomes

There were obvious parallels between the two labour prime ministers, Hawke and Lange, and between the radical finance ministers, Douglas and Keating. However, whereas Lange gave Douglas a free hand in economic policy, Hawke played a dominant role, at least in the early years of the government. Hawke’s approach to politics was based on negotiation and consensus, symbolised by the Summit conference on prices and incomes held shortly after his government took office. Douglas favored rapid implementation of reforms on a broad front, on the assumption that when the benefits of reform were evident, popular support would follow (Douglas 1993).

Structural differences were equally important. Douglas’ authoritarian

approach was made easier by the fact that New Zealand is a unitary state with a unicameral Parliament. In Australia, by contrast, national governments have normally had the support of a reliable majority in the House of Representatives, elected by constituencies, but not in the Senate, which is elected by a system of proportional representation. In addition, power is divided between national and state governments, and all governments are constrained by the constitutional limitations associated with a federal system.

In both Australia and New Zealand, the labour governments elected in the 1980s were reluctant to apply the logic of free-market reform to sensitive areas including labour markets, community services and social welfare policy. Partly because the Australian government survived longer, and partly because its policies in these areas were more successful, free-market reform in these areas has been limited in Australia, though there have been significant movements towards competition and contracting out of service provision. The New Zealand Labour government failed to address the problems of labour markets and the community services sector, leaving the way open for the radical reforms of the Bolger National government. These included the Employment Contracts Act, reductions in social welfare benefits and a new health system based on consistent application of the 'purchaser-provider split'.

Outcomes

Assessment of economic performance is always complicated by the need to choose appropriate comparison periods and appropriate counterfactuals. However, these difficulties are relatively minor in the present case. The Australian and New Zealand business cycles have generally been synchronized, with both countries experiencing severe recessions in the period 1989–91, and subsequent recoveries. However, the expansion phases in both the 1980s and 1990s were more uneven in New Zealand than in Australia.

A further difficulty is that the pattern of employment growth differed across the cycles and between countries. Australia experienced strong employment growth with relatively weak productivity growth in the 1980s expansion, and the reverse pattern in the 1990s expansion. In New Zealand, the 1980s was a period of strong productivity growth and weak employment growth, while the 1990s had strong employment growth and weak productivity. Advocates of the view that one or other country's policies were preferable have tended to shift their ground accordingly.

Considering the period since 1983 as a whole, however, Australia's economic performance has clearly been superior. Australia's GDP per capita grew at an annual average rate of 2.3 per cent, compared to 1.1 per cent for New Zealand. The result was that income per capita in New Zealand fell from around 85 per cent of the Australian level to around 65 per cent today (based on conversion at current exchange rates). Australia displayed higher annual rates of employment growth (2.1 per cent against 0.9 per cent) and productivity growth (1.4 per cent against 0.9 per cent).

New Zealand's poor aggregate performance was accompanied by growing inequality in earnings and a more regressive tax system. Stephens (1998, p19) concludes 'Without making any value-judgements, we could say that all measures of income distribution in New Zealand have widened over the past fifteen years', a view consistent with that of Easton (1996). Income inequality also increased in Australia, but more modestly.

A somewhat more favorable view of the outcome of the New Zealand reforms may be obtained from a comparison of performance over the reform period since 1984 with relatively poor performance prior to 1984. Evans et al. (1996) examine GDP per working age adult, and conclude that New Zealand's growth since 1984 has been superior to that prevailing in the previous seventeen years, and that performance was particularly strong after the labour market reforms of 1990. This result is very sensitive to the choice of measure and to the timing of starting and

ending points of the cycle. Similarly, Evans et al. quote the conclusion of Stephens, Frater and Waldegrave (1995) that relative poverty in New Zealand did not increase during the reform period, but fail to quote the conclusion that absolute poverty did increase. The estimates of Evans et al. have been criticised by Dalziel (1998) on this and other points.

Explanations for failure

Advocates of free-market reform in New Zealand initially expected that their policies would yield clear benefits within a few years. The disappointing outcomes of reform in the 1980s were sometimes explained on the basis of a claim that New Zealand was a 'basket case' prior to the introduction of reform. However, although there were substantial imbalances associated with the Muldoon government's resistance to devaluation and the 'Think Big' policy of resource-based industrialisation, there were similar imbalances in many European countries. Moreover, New Zealand's economic institutions and policies were not radically different from those of Australia or the OECD as a whole. Arguably, New Zealand's trade policies were at the restrictive end of the spectrum, but the ratio of government expenditure to GDP was not particularly high, and labour markets were less regulated than in many European countries.

The fifteen years that have elapsed since the reforms began make it implausible that the policies of the pre-reform era can explain poor performance since reform. Fifteen years is sufficient time to replace the majority of the capital stock, even in the absence of the extensive scrappage associated with rapid structural change. Similarly, most current workers entered the labour force either during the reform period or shortly before its commencement. It is difficult to see how current economic performance could be much affected by the trade and fiscal policies of the 1970s and earlier.

Some advocates of reform have expressed the view that poor economic outcomes are the result of too little, rather than too much, reform. The slowdown in reform during the 1990s is interpreted as a result of 'reform fatigue', and is regarded as a failure of resolve rather than as the result of a popular judgement that previous reforms had failed to deliver the expected benefits. The strongest form of the 'reform fatigue' hypothesis is the claim that the reform process was abandoned just as its benefits were becoming apparent (Kerr 1999). The central focus of this version of the argument is the economic recovery of 1993–1997 and especially the 'two good years' 1994 and 1995, when output grew at annual rates of 5 to 6 per cent.

The 'reform fatigue' argument suffers from severe difficulties. Most importantly, when the economic experience of the 1990s is viewed as a whole, it is difficult to reject the hypothesis that the strong growth of 1994 and 1995 was the usual cyclical expansion that would be expected as part of the recovery from a deep recession. More generally, if the benefits of a decade of radical reform can be negated by a modest slowdown in the pace of reform over a few years, it would seem that the policy program is too fragile to be implemented successfully, at least in a democracy.

If the 'basket case' and 'reform fatigue' explanations for New Zealand's poor performance are rejected, it is necessary to focus on aspects of the reform program that may have contributed to poor economic performance. Most attention has focused on monetary policy. Specific decisions of the New Zealand Reserve Bank in relation to monetary policy, and particularly its reliance, from 1997 to 1999 on a 'Monetary Conditions Index' have been criticised as leading to excessive monetary contraction. More generally, it has frequently been argued that the complete independence of the Reserve Bank and its exclusive focus on an inflation targets have led to excessively restrictive policy (Bean 1999).

The financial deregulation of the 1980s has also been criticised. In a number

of countries during the 1980s, financial deregulation led to a speculative boom in asset prices, and a subsequent slump, but nowhere was the variation in asset prices more severe than in New Zealand. Easton (1997b) argues that the misdirection of investment during the boom and the destruction of capital during the slump were major contributors to New Zealand's subsequent poor economic performance.

A related criticism of financial deregulation stems from the debate on the sequencing of reform, which has focused on the experience of post-Communist countries, and, more recently, the Asian financial crisis. Although there is no consensus on this topic, it is frequently argued that full-scale financial deregulation should not be undertaken until the process of economic reform is well advanced. Early financial deregulation, it is argued, is likely to result in speculative excesses, like those observed in Australia and New Zealand.

External balance

Concern about the 'stop-go' growth associated with periodic balance-of-payments crises was a feature of the policy debate in Australia and the United Kingdom as well as New Zealand during the 1960s and 1970s. Support for programs of free-market reform in all three countries was motivated, at least in part, by the hope that improvements in microeconomic efficiency would solve the macroeconomic problem of 'stop-go' growth. Advocates of the 'twin deficits' theory also argued that an increase in public sector saving would produce an automatic reduction in the current account deficit.

Critics of radical reform also focused on problems of external balance. In particular, Easton (1997b) has argued that New Zealand was successful in diversifying its export mix between 1966 and 1980, and that subsequent poor performance is largely due to the adverse impacts of reform on the traded goods sector. Easton argues that the tight monetary policy and high real interest rates

associated with reform have led to the maintenance of real exchange rates, resulting in an excessive contraction of the traded goods sector and chronic current account deficits.

Inappropriate privatisation policies have also contributed to the current account deficit. Privatisation will generate welfare losses if public assets are sold to foreign buyers for less than the present value of the future stream of earnings they would have generated under continued public ownership (Rankin 1995). The loss takes the form of a net outflow in payments to owners of capital as the profits accruing to the new owners exceed the interest savings arising from the use of sale proceeds to repay debt. For example, Kelsey (1997) argues that the sale of Telecom New Zealand to two American companies for \$4.25 billion in 1990 was a bad deal for the New Zealand public, and that the flow of repatriated profits represents a permanent burden on the current account. Even allowing for the possibility of more vigorous competition in future, it seems clear that the profits foregone through the privatisation of Telecom New Zealand exceed the interest savings from using the proceeds to repay public debt.

Human, natural and social capital

The arguments presented so far are consistent with the view that the reforms implemented in the 1980s and 1990s were appropriate, even if mistakes were made in their design and implementation. However, critics of the reforms such as Kelsey (1997) and Hazledine (1998) argue that the attempt to replace public provision of goods and services with market provision is fundamentally misconceived, and destructive of human, natural and social capital.

These critics focus primarily on microeconomic aspects of the reforms such as privatisation, and market-oriented reforms in the health, education and welfare sectors. The attempt to reform the health system is widely recognised as a failure.

Easton (1997a) argues that the purchaser–provider split model, on which the health reforms was based, rested on the assumption that generic managerial skills, rather than detailed knowledge about health, were crucial to health system managers. Easton argues that the lack of health-specific expertise on the part of managers contributed to the failure of the reforms.

Many writers on economic growth have argued that the development of human capital through education is a crucial determinant of future economic performance. In general, however, the advocates of reform in New Zealand either disregarded human capital, as for example, did Evans et al. (1995) in their discussion of education reform, or were actively hostile to the concept. The National government cut education spending from 6.2 per cent of GDP in 1990 to 4.9 per cent in 1996 and commenced a series of market-oriented reforms based on the purchaser–provider split model. The reforms were significantly influenced by the ideas of Maglen (1990) a critic of the human capital model who argued that most university education consisted of socially unproductive ‘screening’. (This issue is discussed in more detail by Quiggin (1999).)

The reforms in general and particularly the cuts to social welfare are seen by Hazledine (1998) as undermining social capital and interpersonal trust. Writers such as Putnam (1993) and Fukuyama (1995) have argued that the preservation of social capital is crucial to economic and social success in the long run.

An assessment

No single cause appears sufficient to explain the failure of free-market reforms in New Zealand to yield the expected outcomes. It seems clear that macroeconomic misjudgements played a major role in the failure to achieve sustained growth during the 1980s and 1990s. The microeconomic reforms appear to have had, at best, a modest effect in increasing economic efficiency in the short term, while leading to a

substantial increase in the inequality of income and wealth, which is likely to hamper growth in the long term. In some important cases, including privatisation and the reform of the health sector, it seems likely that reform has worsened economic performance in both the short and the long run.

Even allowing for all these factors, the divergence in economic performance between Australia and New Zealand since 1980 is surprising and puzzling. One possible explanation is that the general tendency towards international and inter-regional convergence in income, evident at least since World War II, has been replaced by a tendency towards divergence, as liberalised international markets concentrate wealth in a few 'global cities'. In the Australasian region, Sydney appears to have benefited from trends of this kind while other cities have fallen behind. Within New Zealand, the same phenomenon may be seen on a smaller scale in Auckland.

If correct, this explanation of the failure of reform would contain a bitter irony. Few governments have embraced the global free market more eagerly than the New Zealand governments of the 1980s and 1990s, and few have received more praise from the advocates of globalisation. However, sentiment counts for nothing in global markets, whereas the advantages and disadvantages of location seem to be increasingly important.

Concluding comments

The analysis of economic policy is not an experimental science. It is impossible to observe the outcomes of particular policies in isolation, without taking account of the impact of other policies, and of domestic and international shocks.

That said, the New Zealand experience is as close to an experimental test of radical free-market reform as we are likely to see in a developed country. The results of the experiment have been very disappointing when compared to the hopes

of the advocates of reform. At most, it could be argued that microeconomic reform has yielded modest efficiency benefits that have been more than offset by macroeconomic misjudgements and external shocks.

An assessment of the social impacts of the reforms is beyond the scope of the present paper. Supporters of the reforms, such as the New Zealand Business Roundtable, welcome the social changes arising from the reforms, which they see as creating a more dynamic and enterprising society. Critics, and, it would seem, the majority of New Zealanders, place more emphasis on the negative effects including increased inequality and insecurity.

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