No More Free Beer Tomorrow? Economic Policy and Outcomes in Australia and New Zealand since 1984

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There are no controlled experiments in macroeconomic policy, nor in systematic programs of microeconomic reform, but a comparison between New Zealand and Australia over the period since 1984 provides as close an approach to such an experiment as is ever likely to be possible. From quite similar starting points the two countries pursued liberal reform programs that differed sharply, mainly as a result of exogenous differences in constitutional structures and the personal styles of the central actors. Australia followed a more cautious, piecemeal, consensus-based approach, whereas New Zealand, in contrast, adopted a radical, rapid, ‘purist’ platform. The NZ reform package was generally seen by contemporary commentators as representing a ‘textbook’ model for best practice reform. However, Australia since 1984 has performed much better than New Zealand, whose per capita GDP growth indeed ranked at or near the bottom of the OECD. In this paper, we assess a variety of explanations for the divergences in policies and outcomes.

Introduction

There are no truly controlled experiments in macroeconomic policy, or in systematic programs of microeconomic reform, but we get closest when countries with similar histories and problems adopt different policy responses for identifiable contingent reasons. Economic policy in Australia and New Zealand over recent decades provides a striking example. Facing similar circumstances in the early 1980s, and with the same general set of policy options, governments in the two countries took

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significantly different approaches to the selection and implementation of reform options. Australia followed a path of gradualism and consensus while New Zealand policy makers elected to 'crash through or crash'. At the time, most observers thought that New Zealand was on the verge of success, but in retrospect it seems clear that Australia has performed better.

In this paper, we compare the experience of Australia and New Zealand over the period of microeconomic reform that began in the early 1980s. Of particular concern is the question of how New Zealand, with what were seen at the time as the 'best' set of economic policies in the OECD, experienced the worst set of economic outcomes, and why Australia, from a broadly similar starting position, did so much better. That the outcomes indeed have differed significantly was perhaps not conclusively clear in earlier work (Easton and Gerritsen 1996; Hazledine 1998; Quiggin 1996, 1998), but we are by now in a position to update the earlier comparisons with the advantage of what is now two full decades of history since the major 'reform' processes were set in train.

The New Zealand reform package pre-dated and largely presaged the 'Washington Consensus' (Williamson 2004) on economic policy reform based on the triad of liberalisation, privatisation and stabilisation, which provided the ideological and theoretical underpinnings of the push towards globalisation of the past decade and a half. The New Zealand experience thus generates the longest-running continuing case study of globalisation policies in action, and the comparison of NZ with the performance of Australia both informs the debate on the appropriateness of conventional globalisation policies and provides insights for the emerging (or re-emerging) debate on the possibility of policy alternatives.

The paper is organised as follows. The second section deals with the historical parallels between Australia and New Zealand, the divergence in policy approaches and economic performance during the 1980s and 1990s, and more recent signs of convergence. The third section focuses on New Zealand's poor performance, while the fourth section highlights Australian differences. Finally, some conclusions are offered and implications for globalisation are discussed.

Convergence and Divergence

For most of the twentieth century the economies of Australia and New Zealand moved in parallel, as did developments in economic policy. Both countries were early practitioners of 'socialism without doctrines', encompassing the policy failures of the Depression years, leading to the election of Labour governments that expanded and modernised the welfare state during and immediately after the war.

In both countries a long period of post-war political dominance by the conservative parties was interrupted by the election in 1972 of Labour governments, each of which, however, failed to respond adequately to the economic crisis of the early 1970s, and lost office in 1975. Although the conservative governments elected in 1975 (Muldoon and Fraser) were seen, at the time, as representing a marked shift to the political Right and a break with the welfare-state policies of the post-war period, they were criticised in retrospect for having missed an opportunity to undertake more extensive, and more market-oriented, reforms.

1We use the NZ spelling throughout when referring to both parties, and the Australian spelling to refer specifically to the Australian Labor Party.
Despite this somewhat anachronistic criticism, the general policy tendency of both
the Muldoon and Fraser administrations was actually towards economic liberalis-
sation. A particularly important development was the Closer Economic Relations
agreement implemented in 1983, which replaced the earlier New Zealand–Australia
Free Trade Agreement and removed most barriers to flows of goods, capital and
labour between the two countries.

In both countries, prospects for resource-based economic expansion led to an
inflationary upsurge in the early 1980s, and the imposition of wage–price freezes.
The failure of resource-based prosperity to materialise and the associated atmosphere
of crises led to the fall of the Muldoon and Fraser governments.

Labour returned to office in Australia in 1983, and in New Zealand in 1984, and
from this point policy began to diverge. Although both governments abandoned
stated policies of increased intervention and instead pursued market-oriented policies
aimed at 'opening up the economy', the New Zealand government was more consist-
ently market oriented and notably more radical in its approach to reform.

The central ideological difference between the two governments can be traced to
the long-standing commitment of Australian Prime Minister Bob Hawke to a policy
of bargained consensus. Hawke's focus on consensus moderated the push for reform
in two main ways. First, where policies failed to gain support, or at least acquies-
cence, from business and unions, they were usually not pursued. Equally signifi-
cantly, the consensus approach involved the adoption of policies that facilitated
modest reform but were antithetical to the radical 'shock therapy' approach
adopted in New Zealand. As an important example, the Prices and Incomes
Accord, after failing to secure employers' support, became a bilateral agreement
between government and the Australian Council of Trade Unions (ACTU) involving
various policy concessions in return for sustained moderation in real wages.

In sharp contrast, the New Zealand approach was to try and destroy the power of
unions, seen as enemies of labour market 'flexibility', rather than to work with them.
With Prime Minister David Lange focused on social and foreign policy issues, econ-
omic policy was left to radical Finance Minister Roger Douglas, supported by like-
mined junior ministers, and an ideologically united economic policy community
encompassing the Treasury, the Reserve Bank and the powerful big-business
lobby group the New Zealand Business Roundtable. Douglas implemented a series
of reforms that made New Zealand a focus of world attention for a decade or
more and which earned them (from Brian Easton) the label 'Bolsheviks of the Right'.

The divergence grew even greater after Labour lost office in New Zealand in 1990.
In violation of its election platform, the Bolger National government embarked on a
new round of radical reform addressing areas that had been too politically sensitive
for the Labour government. The most important were industrial relations, social
welfare and health policy. Meanwhile, although Paul Keating, who succeeded
Hawke as Prime Minister in 1992, implemented some further reforms, the pace
was slowed substantially. Despite the unpopularity of the Keating government,
voters rejected the Fightback! package of radical free-market reforms offered by
Liberal leader Hewson in 1993.

It was only with the election of the Howard Liberal government in 1996, and Clark
Labour government in 1999 that signs of convergence began to emerge. While the
Howard government has taken a generally cautious approach to reform it has
sought to implement much of the "unfinished business" left behind for various
reasons by Labor. Although some measures were blocked in the Senate, the publicly
owned telecommunications carrier Telstra was partially privatised in the government’s first term, and a Goods and Services Tax was introduced in its second. Since the government gained a (not totally reliable) majority in the Senate in July 2005, signs of a more radical approach to reform have emerged, most notably with respect to industrial relations, where an attempt has been made to push far-reaching reforms through parliament with minimal discussion and debate. Nevertheless, even these reforms are less radical than the New Zealand Employment Contracts Act.

In New Zealand, the reformers were discredited by a renewed economic downturn that began in 1997, after a few years of strong economic growth had led them to declare that the reforms were finally working. The National Party, in coalition with the populist NZ First, did little in the way of reform in its final term in office, which ended in defeat and the election of a coalition of Labour and its Left-wing offshoot, the Alliance Party. The new government immediately reversed a few of the most extreme measures of its predecessors, raising the top marginal rate of income tax from 33% to 39% and amending the Employment Contracts Act to recognise unions and support collective bargaining. Adverse business reaction to these changes soon induced a more cautious approach. Nevertheless, the general tendency of policy under the Clark Labour government has been away from radical free-market reform and towards more ‘mainstream’ policies.

Thus policies may have converged, but outcomes have not. For most of the twentieth century, income per person in New Zealand grew in parallel with Australia. In the 1960s and 1970s the more exposed and undiversified NZ economy suffered more than did Australia from two large external shocks (Dalziel 2002)—the 40% fall in the real world price of wool 1967–68, and further terms of trade shocks from 1973, with falls in export commodity prices and the accession of the United Kingdom to the European Union. Despite these shocks, in 1983, on the eve of the NZ policy revolution, the gap in GDP per capita between the countries was only 5% in Australia’s favour.

From New Zealand’s perspective, the next 17 years were a period of almost unmitting deterioration in the output gap between the two countries, which by the turn of the century had reached 33%, a huge difference to have opened up in such a short period. Compared to the OECD in general, the widening gap is partly due to Australia doing quite well, but mostly to New Zealand’s growth performance up to 2000 ranking bottom—26th out of 26!—in the OECD (Hazledine 2003). Since the turn of the century, New Zealand’s quite strong recent growth has clawed back a little of the income difference, but parity remains, and is likely to remain, an increasingly distant memory.

However, the most recent data do suggest that it is possible that the two economies are now on similar growth paths, albeit a long way apart. In other dimensions of macroeconomic performance, inflation rates have been low since the 1990 recessions, and unemployment has now fallen back to rates roughly similar to those prevailing in the 1970s before the reforms began. In common with other English-speaking countries, rates of household saving have fallen, and there are substantial deficits in goods and services trade and on the current account.

New Zealand: What Went Wrong?

It seems that New Zealand had the ‘best’ set of economic policies and possibly the worst set of economic outcomes in the OECD over the past 20 years. Something
wrong, surely? In this section we cross-examine some of the usual and not-so-usual candidates for the role of spoiler in the unfolding of the neo-liberal plan, with Australia and its less radical reforms and much more successful growth path cast as a possible counterfactual.

It Could Have Been Worse

After reviewing the numbers comparing New Zealand’s economic performance with that of other economies, the Australian economist Bob Gregory (1999, 10) concludes, rather mildly, ‘It is perhaps difficult to believe that the outcomes could have been worse if there were no reforms at all.’ But not everyone agrees with this. The implied counterfactual is continuation of the old ‘Albania of the South Pacific’ regime, to eventually founder under its inherent rigidities and contradictions, à la Cuba, North Korea or indeed the actual Albania. A less colourful version of the same claim is presented by Bollard, Lattimore and Silverstone (1996, 23):

New Zealand’s economic reform process may still rank as one of the more successful by world standards, with the potential to improve economic wellbeing compared to the outcomes from an unreformed economy. (Emphasis added)

But this is a straw man, for four reasons. First, it exaggerates the extent of planning and controls pre-reform. The old New Zealand was in fact a firmly capitalist economy, with a quite high trade ratio, a moderate ratio of government expenditure to GDP, and a labour market actually relatively unregulated by European standards. There were indeed quite a lot of rules and regulations, some of them rather silly, but not a pervasive system of activist planning and dirigiste allocation of investment resources, at least until the Muldoon/Birch ‘Think Big’ escapades of the early 1980s. Second, the ‘Albania’ caricature ignores the quite considerable program of reform and liberalisation that was well underway by 1984, including the important (to New Zealand) free trade agreement with Australia (and the continuation of open labour markets across the Tasman), the abolition of compulsory unionism, and the deregulation of internal freight transportation. The sensible counterfactual to Rogernomics is continuation of gradualist reform, not stasis. Third, the implied prediction of even greater divergence between Australia and New Zealand had New Zealand followed policies more similar to those of Australia is implausible, particularly given free movement of labour, capital and goods between the two economies. Finally, casting around for an even more unattractive counterfactual just diverts attention from the actual factual. Whatever would have happened otherwise, we still need to know why the new New Zealand in fact performed poorly compared with Australia.

You Wouldn’t Want to Start from There

A common theme in discussion of New Zealand’s poor performance was that New Zealand was an economic ‘basket case’ before the reform period. When the weakness of New Zealand’s performance became evident in the late 1990s this claim was offered as evidence in defence of the reforms, saying that nothing better could have been expected given such a desperate starting point. A measured statement of the argument, or assertion, as paraphrased by Easton and Gerritsen (1996,
43) is that 'New Zealand, as a result of Muldoon's interventions, was much worse placed than Australia in the early 1980s.'

Any such distinction is one of degree, rather than kind. Muldoon's most prominent single intervention, the wage-price freeze, was matched by the Fraser government in Australia. Micro-level interventions such as agricultural price stabilisation schemes, restrictions on trading hours, labour market intervention and so on were not radically different in the two countries. New Zealand persisted longer with some forms of intervention, such as import quotas, than did Australia, and was more bound by regulation than Australia, though perhaps no more so than states like Queensland, where intervention of all kinds was a bipartisan tradition.

To the extent that New Zealand before 'Rogernomics' was an economy unusually bound and restricted by regulation, there is a problem in the argument regarding levels and growth rates. Within the paradigm of mainstream economics such restrictions result in distortions which would be a drag on productivity and efficiency, a 'deadweight loss' to the country's productive potential. That seems reasonable, but what is puzzling is how the inefficient state of the economy before reform would generate poorer performance afterwards.

It is difficult to make sense of this, at least within the context of a mature capitalist society with well-established markets and property rights, as was New Zealand (in comparison, say, to the states of the former Soviet Union). Dismantling the shackles of over-regulation should have freed up the economy to make a great leap forward, bequeathing at the very least a one-off but substantial 'deadweight dividend' from the shedding of inefficient practices. The further an economy is from its potential frontier, the faster it should grow towards that frontier when the restrictions are removed.

Free Beer Tomorrow!

Enthusiasts for the reforms have for some time been promising that success is just around the corner. There have also been two periods when claims were made that the gravy train had finally arrived. The first of these proved premature; the second, arguably, too late. The paper by Evans et al. (1996) is the best-known exposition of the first wave of premature triumphalism. Following just two years of quite fast economic growth around 1993–94, these authors conclude that New Zealand 'is on a trajectory to maintain its economy as a consistent high performer among the OECD (quoted in Dalziel 2002, 33). Unfortunately, growth fell every year after that for four years, and the 1993–94 spurt now appears to have been no more than a normal cyclical expansion following the very deep (policy-induced) recession suffered at the beginning of the decade.

After 1998, however, growth picked up again, and has been strong for the past five years, with the aid of favourable terms of trade for New Zealand's primary exports and a tourism boom. If we start counting from the most favourable possible point—the trough of the recession, in 1992—average annual real GDP growth to date comes out as 3.7%, which is not much lower than Australia's growth rate of nearly 4%. This has enabled one of the most persistent proponents of hard-Right policies, Roger Kerr of the New Zealand Business Roundtable, to claim that 'Those who argued for the reforms have been proved right and their critics have been proved wrong' (Kerr 2005).

A different interpretation of the same figures might be that the New Zealand economy is finally showing signs of recovering from the damage done to it by the
ill-judged policies of Muldoon and Douglas in the 1980s. Unfortunately, although New Zealand’s recent growth path has almost matched that of Australia, it has not been anywhere near sufficient to close the huge output gap opened up in the aftermath of the reforms.

An alternative to the Pollyanna approach is the ‘reform fatigue’ argument, which attributes any disappointment in results to there being not too much reform, but too little. This view attributes the decline in policy radicalism after 1991 to a failure of resolve, rather than to a popular judgement that the (very substantial) basket of 1984–91 reforms had failed to deliver the promised results. This argument was often used when the economy was performing poorly, for example by Kerr (1999); a variation is required when, at last, New Zealand has managed to string together a decent number of consecutive years of quite strong economic growth. Thus we have Roger Kerr (2005) again:

What matters now is not past progress but the outlook in the period ahead. The government’s own projections have GDP growth falling away . . . So New Zealand is at risk of falling behind other countries again after holding its own in the past 10 years. Why the deteriorating outlook? The answer isn’t hard to fathom. In a presentation to a Business Roundtable meeting last month, Roderick Deane listed more than 25 significant Government initiatives that are harming our growth prospects. Leading items include the growth of government spending, the increase in the top tax rate, the restoration of the Accident Compensation Commission monopoly, the re-regulation of the labour market, the slowdown in the pace of tariff reductions, the growth in state ownership of businesses, increasing regulation of banking, telecommunications and electricity, takeover regulation, more expansive local government legislation, ratification of the Kyoto Protocol, more central control of health and education and more lenient welfare rules. It would be easy to add to the list . . .

But the facts are that New Zealanders are not particularly heavily taxed, have a weak trade union movement, almost no tariffs left to reduce, an unusually ‘light-handed’ regulatory regime and that the country comes out at or near the top of international lists of openness and business-friendliness. Could it be that the problem is too many of these policies, not too few? This point is particularly clear when comparisons are made with Australia. With the exception of the Kyoto Protocol (Australia has not ratified the Protocol but the government has promised to meet the targets it sets out for emissions reductions), all the points on Kerr’s list are familiar complaints from market-oriented critics of Australian government policy. Attempts to privatise workers’ compensation have been unsuccessful, the pace of tariff reductions has slowed, infrastructure regulation has been criticised as over-intrusive, centralisation of health and education policy has been a source of constant dispute, and so on. If imperfect adherence to free-market orthodoxy explains New Zealand’s failure, Australia should also have performed poorly.

Poor Implementation

Perhaps the reforms were ‘correct’ in the sense that an economy running smoothly with these policies in place would outperform the ‘same’ economy running smoothly without them, but the process of implementation was flawed: in particular because policies were introduced too quickly and/or in the wrong order, thereby generating adjustment shocks. There almost certainly is merit to this argument, and it
conceivably could even account for all of the performance shortfall (though we don’t think it does). There are two elements to the story: speed and sequencing.

The speed with which the reform program was implemented is truly astounding. Of the 104 reforms listed by Bollard, Lattimore and Silverstone (1996) between 1984 and 1991, 65 were completed or well underway by the end of 1988. Presumably this could only have been achieved politically in New Zealand’s ‘elected dictatorship’ system—unicameral, first-past-the-post (at that time), no provincial or State governments—but even so the single-mindedness of the reformers was impressive. The Treasury, in particular, though a great proponent of the doctrine of ‘contestability’ everywhere else in the economy and society, did a very good job of suppressing any competition in its own sphere of activity, namely the provision of economic policy advice. The Treasury supported slashing the funding of the independent New Zealand Institute of Economic Research and systematically stamped out the capabilities of other government departments to undertake policy research.

Why so fast? At the time, the government claimed the force majeure of macro-economic crisis, being the legacy of the mismanagements of late-Muldoonism. But while action was required, the emerging historical evidence strongly suggests that the crisis was used as a political excuse for the revolutionaries to do what they wanted to do, rather than being dictated by the economic logic of the situation in 1984 (Hazledine 1998, 28–9).

Was speed harmful? There is, of course, an argument or proposition that if a change is desirable, then best do it quickly, the sooner to reap the benefits. In the literature of reform/transition this position has been supported by the proverb: ‘You don’t try to jump the ravine in two bounds.’ In response to this it could be suggested that without time for preparation and practice, any attempt to jump the ravine may fail. In New Zealand’s case, it appears very likely that the hasty dumping of state-owned assets onto the market was something of a ‘fire sale’, and resulted in billions of dollars of net outflows from New Zealand (Kelsey 1997). Other sudden shocks to the system may have been traumatic rather than stimulating.

As for the sequencing issue, even at the time, moderate supporters of the reforms, such as Blyth (1987), worried about deregulating financial and goods markets before reforms designed to achieve greater labour market flexibility. This may have contributed to the chaos inflicted on the real economy by the 1987 stock market crash (the world’s deepest fall in stock prices), and the triple whammy of high interest rates, high exchange rate and loss of protection which was followed by the loss of one manufacturing job in three over the 1988–91 period. However, the key point from a comparative perspective is that Australia adopted much the same sequence of reform. There, the severity of the 1989–90 recession was exacerbated by premature and poorly managed financial deregulation. Nevertheless, in the 15-year expansion that followed the recession, and still continues, Australia regained all the lost output and more, while New Zealand had a short-lived recovery (hailed at the time as the payoff from radical reform) followed by another recession and continued slower growth.

Thus, the comparison between Australia and New Zealand throws little light on the sequencing debate. However, Australia’s superior performance supports the view that the speed with which the New Zealand reforms were implemented contributed to poor observed outcomes. Excessive speed was problematic in itself, since it increased adjustment costs, and was frequently associated with poor implementation and a preference for dogmatism over practicality.
**Bad Luck, Kiwi!**

A respected New Zealand political commentator recently wrote:

> How do you get economic growth down? Have a drought. How do you get it up? Get yourself a cornucopia of metals, gas and oil. A drought in this country cuts deep into GDP. A drought in Australia does not have much effect because agriculture is a relatively small part of the economy. Australia has vast mineral and petroleum riches. New Zealand’s supply is not in that league. So, all other things being equal, Australia’s economy will grow faster than ours. To reverse that, we will need to make the other things unequal. (James 2005)

No competent economist would write that. The fallacy is in the confusion of levels with rates of growth. If you haven’t got any gold you may be poorer, now and for ever, than someone who has got some gold, but there is no reason—at least not in orthodox theory—why your growth path should be permanently flatter (display a lower growth rate) than the resource-rich economy.

The same fallacy is often committed with respect to the effect of distance on prosperity. New Zealand and Australia (but especially New Zealand) are a very long way away from their trading partners. *Ceteris paribus*, the costs of distance will reduce the level of national income in New Zealand. But New Zealand has not shifted further away from the rest of the world over the past decades. Rather, the economic cost of distance has fallen quite sharply, in particular with the innovation of containerisation, the introduction of jet air travel, and the revolution in communications and information technology. Distance should have been a factor operating in New Zealand’s favour over the past 20 or so years, not necessarily relative to Australia, but certainly relative to the other OECD countries whose growth rates exceeded New Zealand’s.

What about economies of scale? New Zealand’s market size is around one-fifth that of Australia, which itself is not a large economy. Scale economies are important in many industries. But, again, this is most naturally seen as a level, not a growth issue, and, again, the massive opening up of New Zealand since 1984 should in effect have increased the extent of its available markets, providing a positive income shock.

Other lucky or unlucky events which affect GDP and which therefore affect short-to medium-term measurement of economic growth are supply shocks, such as droughts, and international demand shocks. Both countries have had some problems with droughts; perhaps Australia’s have been more frequent and newsworthy.

Demand shocks are usually picked up in the terms-of-trade index, which is the ratio of the prices received for exports to the prices paid for imports. Scaling both countries’ terms-of-trade indices to equal 100 in 1984, and extending Paul Dalziel’s IFS data, we find that the average annual value of the index for the 20 years 1984–2003 was 91.8 for Australia and 112.4 for New Zealand. That is, over this period and in comparison to 1984, it is New Zealand that has truly been the ‘lucky country’, not Australia. Since exports and imports are equal to around a quarter of GDP in New Zealand, and a little less in Australia, the difference is significant in economic terms, amounting to a windfall to New Zealand relative to Australia equivalent to a permanent 5% increase in GDP. This makes the shortfall in New Zealand’s GDP performance look even worse.
Wrong Model

Did the reform package fail, at least in part, because it was, fundamentally, misconceived? New Zealand's post-1984 reforms are often described as 'textbook', but this is a misleading description. Even up-to-date texts in microeconomics and industrial organisation lack an integrated treatment of the post-neoclassical concepts that guided the New Zealand reformers. Practice has gone ahead of 'normal science', and in this respect the New Zealand experience can be read as an unusual experiment, testing a theory before it has been fully worked out.

The goal of the reform program was not novel and is well summarised by the title of what is probably the most widely known analysis of recent events in New Zealand: 'The Pursuit of Efficiency' (Evans et al 1996). But it was in their perception of what would be required to achieve efficiency that the reformers moved well beyond the neoclassical orthodoxy based on assumptions of perfect information and benevolent, costless government, towards a more modernist vision of self-seeking individual agents operating with relentless opportunism in an environment fogged by uncertainty and private information. This is the world of agency theory, transaction cost economics and pervasive rent-seeking.

In the public-sector reforms, agency theory was in the forefront, and provided a simple yet powerful analytical framework without which it would hardly have been possible for a tiny band of revolutionaries to implement such a speedy and ferocious program. Agency theory builds from the concept of the principal–agent problem, which arises when someone (the principal, P) tries to get someone else (the agent, A) to do the principal’s bidding. The 'problem' occurs when three conditions are met: (1) P and A have differing objectives; (2) A is prepared to be opportunistic (pursue his or her own objectives); and (3) because of costly (private) information, P cannot easily verify A's actions (or type).

The underlying assumptions were that public administration had been captured by the agents—the civil servants—who wished to follow goals other than (or at least supplementary to) efficiency, and who would have the power to do this as a result of their private information. As reported by Duncan (1996, 397) in his lucid and informative account of the public-sector reforms, these assumptions led to the adoption of the following working principles:

First, the state should not be involved in any activities that would be more efficiently and effectively performed by the community or by private business. Secondly, trading enterprises would operate most efficiently . . . if structured along the lines of private sector businesses. Thirdly, departments would operate most efficiently . . . with clearly specified and unambiguous functions. Fourthly, departmental managers would perform most effectively if made fully accountable for the efficient running of their organisations, without central [political] control.

That is, if the market can exercise the efficiency control function, then privatisation is desirable (telecoms, rail and air transport, forests, banking, and so on). If ownership of a basically commercial function is to remain with the state, then 'corporatisation', requiring the managers to operate on commercial criteria, is desirable (post, broadcasting). If the duties of the department are inherently non-commercial, then quantifiable 'outputs' should be specified as targets and systems of accountability established to give managers the incentives to achieve these goals (health, education, research).
These principles of agency theory were applied at the very highest level, to the politicians themselves. The finance minister is enjoined by the Fiscal Responsibility Act of 1994 to refrain from running persistent operating deficits (or surpluses), to publish various updates and forecasts to demonstrate consistency of budget and underlying economic conditions, and to follow generally accepted private-sector accounting practices in the Crown's financial reporting. But perhaps the most striking example of the application of agency theory has been in monetary policy, reformed under the 1989 Reserve Bank Act. The 'output' of the central bank is defined simply and narrowly as maintaining price stability (CPI inflation within a narrow band) and a substantial proportion of the remuneration of the Governor of the Reserve Bank apparently depends on his success in achieving this goal.

The Fiscal Responsibility Act is generally seen as a success, but monetary policy remains controversial. The contract-based approach is an illustration of the dangers of simple-minded application of agency theory: (a) it is not that the output goal will not be achieved, but that it will, at the expense of other worthy goals (such as employment and profitability) not specified in the contract; (b) the agent's private information enables him to distort the performance signals received by the principal; and (c) there were doubts about the credibility of the whole arrangement, which turned out to be justified when inflation went above the agreed target band of 0–2%. Rather than fire the Governor (or require him to pay back some of his performance bonuses from previous years), the finance minister extended the upper limit to 3%.

As for the private sector (including the privatised elements of the old public sector), the revolutionaries here placed great faith in the power of governance by market forces, given full play to operate by the determined opening up or liberalisation of market institutions. In this regulatory void it was expected that market price signals would shine clearly. The basic proposition of transaction cost economics was invoked:

In the absence of government imposed distortions, the form of private sector economic organisation which survives in the marketplace is likely to be that which delivers the goods and services demanded by consumers at the lowest combination of production and transaction costs, including agency costs. (Jennings and Cameron 1987, 131)

This position represented a paradigm shift from the old New Zealand 'market failure' model, in which pervasive government intervention was justified by the failure of unregulated markets to perform well due to market power, externalities, and short time horizons, to a 'government failure' model, in which inefficiencies were due to those 'government imposed distortions', such as rent-seeking, impediments to free competition, and crowding-out of private-sector investments. The fear of government failure was taken to extremes not seen in other market economies. The newly privatised network industries, many of which were incumbent monopolies, were all allowed to make their new way without public administrative interference, under a regime known officially as light-handed regulation, though perhaps more accurately to be dubbed 'no hands'.

Hazledine (2001) has examined the empirical implications of the new regime, applying the pioneering US research of Wallis and North (1986) to Australian and New Zealand data. Wallis and North distinguish 'transformation' and 'transaction' sectors of the economy. The former involves the act of production of useful goods
and services; the latter accounts for the measurement/monitoring/managing activities that are needed to keep complex modern production and distribution systems operating. Hazledine found that, as in the United States, the share of GDP taken up by the transaction sectors of the Australian and New Zealand economies has increased over time (to more than 40%). However, growth in the transaction sector over the past 20 years was higher in New Zealand, with almost all the difference accounted for by what amounts to an explosion in the number of managers in the New Zealand private and public sector. The share of managers in total employment is 5 percentage points higher in New Zealand than in Australia.

This may seem a paradox: 'more markets' has meant more managers! But from the perspective of agency theory it is not unexpected: more monitoring of agents does mean more supervisory input, from managers and others. If the theory is valid (as a theory of effective reform) then the more intensive supervision should pay off in much higher productive efficiency, such that fewer production workers actually produce more in total.

But what if agency theory, applied single-mindedly, is wrong? In particular, what if its basic premise of the pervasiveness of rational opportunistic individualists ignores (and in application may actually discourage) the norms of trusting and trustworthy social and business interactions that in fact are absolutely essential to functioning civil society? The economic calamities that befell the Eastern European and Soviet states in the 1990s after the fall of communism may be the most vivid and obvious case study of the economic importance of trusting/trustworthy behaviour. Perhaps New Zealand's disappointments are another, fortunately less extreme, example.

Corroborating evidence for this position comes from a growth-accounting analysis by Black, Melody and McLellian (2003), who attribute nearly all of the growth differential between Australia and New Zealand to higher private-sector investment rates in Australia. In terms of the metaphor, New Zealand created a level playing field, but nobody turned up to play. Australian policy makers, with their more cautious, cooperative, even corporatist approach, made sure they had a team ready to go onto the pitch, and were not beyond encouraging it with a tilt of home-field advantage. As a result they got the greenfield investment that in the long run is essential to increased prosperity, as reflected in the vastly larger capitalisation of the Australian stock market compared to its New Zealand counterpart.

**Australia—What Went Right?**

In considering Australia's strong economic performance relative to New Zealand and (at least since the early 1990s) the rest of the world, two issues must be considered. First, why did Australia adopt a more gradual and cautious approach in implementing the 'standard package' of market-oriented reforms advocated by the OECD? The constitutional and personal factors discussed in the second section of this paper are most important here.

Second, what was the effect of specifically Australian policy initiatives? In this context, the most interesting issues arise in relation to the Hawke–Keating Labor government, and, in particular, to initiatives associated with the Prices and Incomes Accord between the government and the ACTU. The Accord, which was central to the government's economic policy from its election in 1983 until the recession of 1989–90, was concerned primarily with restricting the growth of real and
nominal wages, and thereby permitting a gradual reduction in inflation, without reliance on restrictive monetary and fiscal policy. In this respect, the Accord was successful in its early years. In particular, the Fraser government's wage-price freeze was ended with less disruption than in New Zealand. Over the course of the 1980s, the underlying rate of inflation declined from around 10% to around 5%, while employment recovered steadily from the 1981 recession.

The final costly episode of disinflation in 1989–91 did not result from the breakdown of the Accord. Although concern about wage pressure was one factor motivating the advocates of a 'short sharp shock', a boom in speculative asset markets and concern about the current-account deficit were more important. Overall, it seems reasonable to conclude that the Accord reduced the cost of disinflation in terms of unemployment and cumulative loss of output.

The need to maintain the Accord encouraged the adoption of a number of policy measures that were not part of the standard reform package and, in some cases, were directly opposed to the ideas put forward by free-market reformers. These proposals were sometimes referred to as constituting increases in the 'social wage'. The most important was the reintroduction of Medicare, a universal, taxpayer-funded system of health insurance that had been introduced by the Whitlam Labor government in 1975, and gradually dismantled under the succeeding Fraser government. The effect of reintroducing Medicare was to reduce the consumer price index, and, under the Accord, the ACTU agreed to reduce its claim for a general wage increase correspondingly.

More generally, and unlike governments elsewhere in the English-speaking world, the Hawke–Keating government sought to improve the operation of the welfare state, rather than simply attempting to cut it back. As a result, the large increases in inequality observed in New Zealand, and in other English-speaking countries, were not matched in Australia, particularly in relation to disposable income after taxes and transfers. Under the Howard government, although benefits for the unemployed and single parents have been tightened considerably, benefits for low-income families have actually been enhanced.

Another interesting policy was the 'industry plan' process, championed by John Button and used to smooth the path of industries facing reductions in protection and increased international competition. Plans were implemented for the motor vehicle, steel and textile, clothing and footwear industries. Of these, the most successful was the motor vehicle plan, which contributed to the survival of motor vehicle production in Australia, despite a reduction in effective rates of protection from over 55% to 10%. The steel and textile, clothing and footwear plans also appear to have contributed to a more gradual adjustment, with smaller loss of output through unemployment and bankruptcy than might otherwise have been the case.

On the macroeconomic side, a contribution to Australia's success has been the absence of a recession, or even a severe economic slowdown, since 1991. It is unclear to what extent this has been due to good luck, good management or the increased flexibility associated with microeconomic reform. New Zealand's recession of the late 1990s was due in large measure to a misjudged monetary policy (associated with the short-lived Monetary Conditions Index) adopted in relation to the Asian crisis of 1997. This comparison suggests, first, that good macroeconomic management is essential and, second, that microeconomic flexibility is of little value in the presence of severe macroeconomic shocks.
Conclusions and Implications for Globalisation

In their chapter on economic reform in *The Great Experiment* (Castles, Gerritsen and Vowles 1996), Brian Easton and Rolf Gerritsen discerned a decade ago the opening up of a performance gap between Australia and New Zealand, despite the superiority of NZ policy in terms of ‘rationalist theory’. They asked how New Zealand’s economic rationalists have rationalised this, ‘on the few occasions they have been willing to confront the poor performance of the New Zealand economy under their policies’ (Easton and Gerritsen 1996, 43).

Easton and Gerritsen discuss two lines of argument. The first, which we rejected above (though not for quite the same reasons as do Easton and Gerritsen), is that New Zealand’s initial conditions were so much more unfavourable than Australia’s as a result of the poorer policies followed in the pre-reform period. The second claim they note is that New Zealand will perform better than Australia in the future.

We are now in a position to fairly conclusively refute the second claim. The output gap that opened up between Australia and New Zealand in the 1980s and early 1990s has proved persistent. The puzzle of the smaller country’s poorer performance, despite its theoretically superior policies, has intensified with the fading away of possible excuses, and of hopes for a rapid resurgence. The explanation suggested by Easton and Gerritsen in terms of the superiority of ‘corporatist vs commercialist’ economic strategies, in particular in the steadier macroeconomic policies thereby permitted, has held up well, and is consistent with our list (in the third section of this paper) of the possible candidates that seem now to be properly rejected.

We will close by asking how the experience of two decades of economic liberalisation in Australia and, especially, New Zealand, fits into, and informs, the wider debate on globalisation. It is often argued that, like it or not, liberalisation is an irresistible force in any single country because it is happening in all others, and we are now all so interconnected that no significant deviation from the policy norm is possible.

But New Zealand did deviate from the global policy norm: it went much further in the direction of radical reform, before its gradual return to the mainstream since 1999. Recent evidence on the ‘border effect’ (Hazledine and Lipanovic 2004) reveals just how persistent the nation-state is as an economic force, even in a ‘world without walls’. Examination of economic policy and policy differences between Australia and New Zealand supports the proposition that nation-states are still free to make choices, including bad choices.

References


