LOSING SIGHT OF THE LODESTAR OF ECONOMIC FREEDOM

A Report Card on New Zealand's Economic Reforms

Wolfgang Kasper

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LOSING SIGHT OF THE LODESTAR OF ECONOMIC FREEDOM

Introduction: How much economic growth is adequate?

A recent paper by a senior Treasury analyst speaks of New Zealand's "disappointing per capita growth and productivity performance" following extensive economic liberalisation in the 1980s and early 1990s.[1]

In one sense, the use of the term 'disappointing' seems surprising. At no stage did the Treasury's own forecasts and projections foreshadow outcomes superior to those actually achieved. Indeed, job creation and the rate of decline of unemployment after the freeing-up of labour markets in the early 1990s far exceeded official expectations. Moreover, New Zealand's real gross domestic product (GDP) grew by an average 3.3 percent per annum in the ten years to 2002; the price level rose by less than 2 percent per annum; and total employment growth was 27 percent, a respectable record by Organisation for Economic Cooperation and Development (OECD) standards (International Monetary Fund, 2001). "On balance, New Zealand's growth performance over the 1990s has been significantly better than in the previous two decades", and "good policy foundations and favourable external conditions have lifted New Zealand's growth rate towards the OECD average", according to the Treasury's August 2002 briefing to the incoming government.

Nonetheless, New Zealand living standards have remained well behind those of the more affluent European countries, Australia, Singapore and Hong Kong. Many observers ask why New Zealand's bold economic reforms did not produce faster and more sustained growth – perhaps even double the actual rate and similar to Ireland's track record after a comparable reform programme beginning in the late 1980s. This paper will try to suggest some answers to that question.

What explains growth?

It is well established that secure property rights, free markets and equality before the law promote rapid economic growth. Thus, the latest issue of what is arguably the most convincing measure of these qualities – the Fraser Institute's 'index of economic freedom' (Gwartney and Lawson, 2002), an index co-published by a network of 54 independent public policy organisations, including the New Zealand Business Roundtable – shows a clear correlation across 123 jurisdictions between economic freedom and income growth during the 1990s. There is also a clear correlation between economic freedom and per

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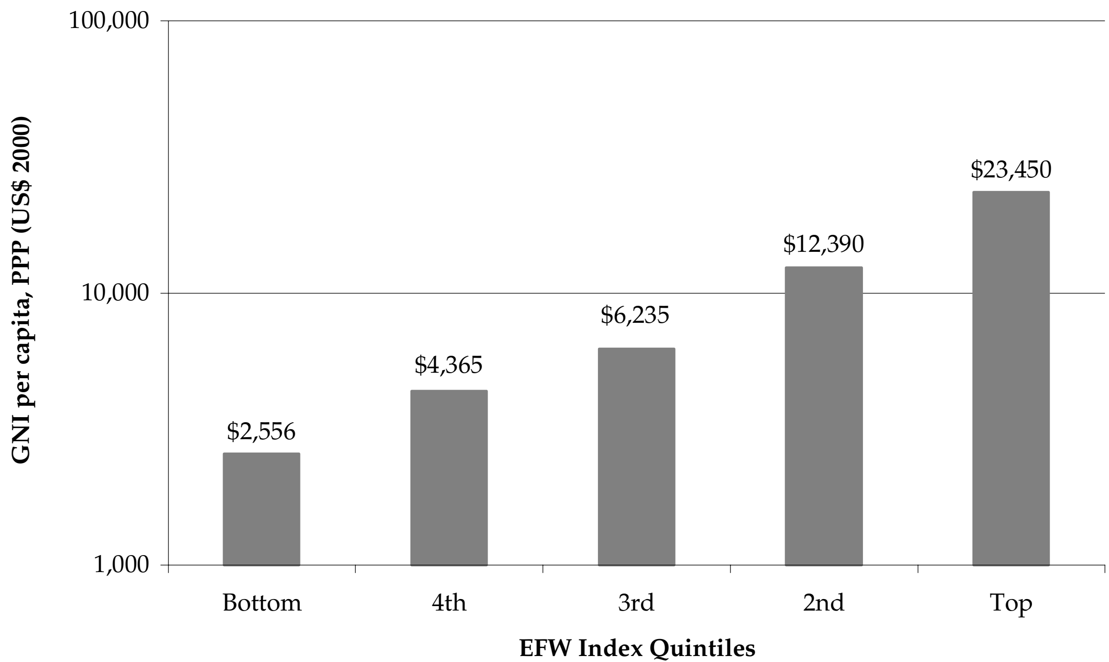
[1] Geoff Lewis (2002). The author led the New Zealand Treasury's Economic Transformation project until mid-2002.

Figure 1: Economic freedom and per capita income



Source: Gwartney and Lawson, 2002.

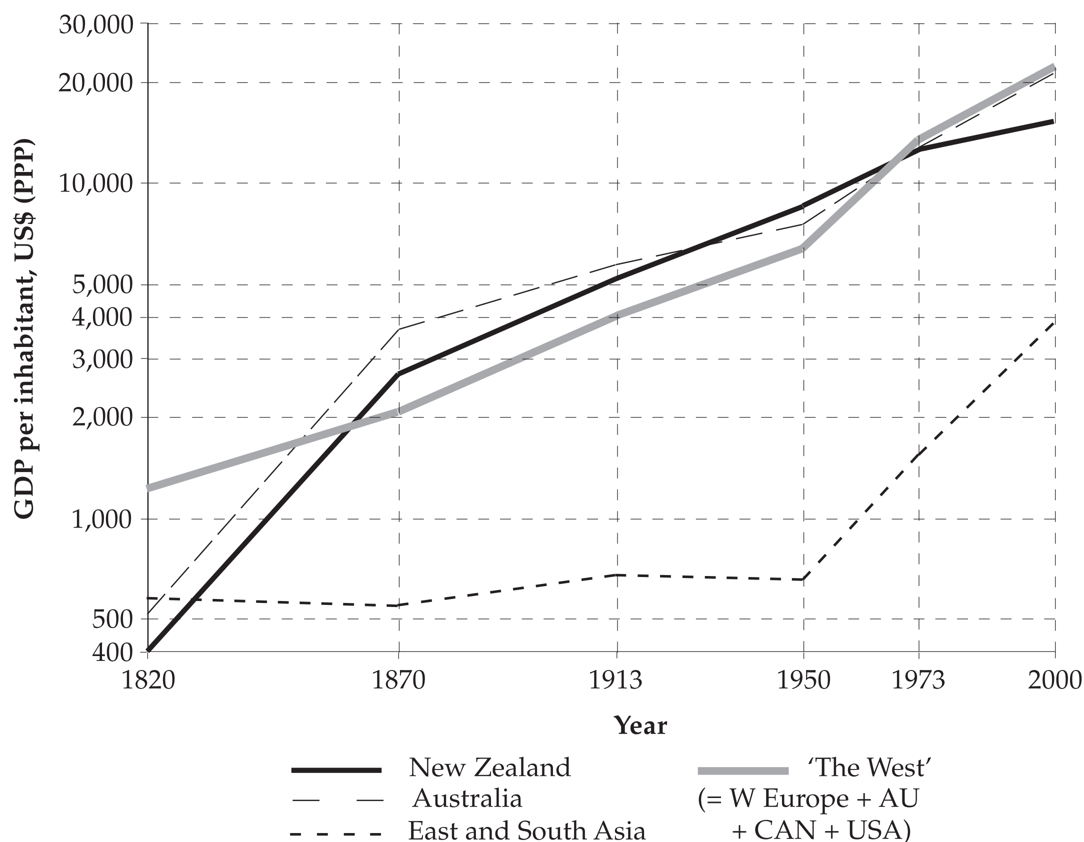
capita incomes across countries, as Figure 1 illustrates. A recent, comprehensive study by Richard Roll and John Talbott found that 85 percent of the differences between the richest and poorest countries on earth can be 'explained' by differences in economic and political freedom (Roll and Talbott, 2001). A growing literature highlights the key role of appropriate institutions in generating economic growth; one can now speak of a new 'institutional growth theory' (Scully, 1992; Easton and Walker, 1997; Gwartney, Holcombe and Lawson, 1999; Kasper and Streit, 1998; de Haan and Sturm, 2000, Easterly, 2002).[2]

The economic reforms that successive New Zealand governments implemented in the years between 1984 and 1994 moved the country high up the international scales of economic freedom. As of 2000 – the latest year for which international comparisons are available – New Zealand is ranked fifth of 123 countries (Gwartney and Lawson, 2002, p 11). This is two places lower than its third-place ranking in 1999, behind Hong Kong and Singapore.

After an improved policy framework was established by the early 1990s, New Zealand's economic growth accelerated, as one would have expected. But from the mid-1990s, it

[2] Contemporary institutional growth theory has long and respectable antecedents. Eighteenth-century writers, such as David Hume and Edward Gibbon, elucidated the central importance of ordering rules to prosperity, and nineteenth-century practitioners of politics and administration who came into intimate contact with non-European cultural and political systems, such as Stamford Raffles, explained differences between misery and progress by differing institutions (Jones, 2002). Institutional growth theory was familiar to Max Weber and Joseph Schumpeter. It was lost with the econometric blinkering of the discipline in the second half of the twentieth century.

Figure 2: Economic growth: New Zealand in an international context



Sources: Maddison, 2001, and own estimates.

failed to keep up with the pace set in the West, Australia, or the wider Asia-Pacific region (see Figure 2; Maddison, 2001). The New Zealand case might thus be seen as challenging the general rule. Indeed, does the country's experience call into question the policy advice of liberal reformers altogether?

Some papers emanating from the Treasury's Economic Transformation project[3] have suggested New Zealand's 'disappointing' growth performance can be explained by its geographic isolation and the small size of its economy. This view can be quickly dismissed. Some small and peripheral economies have attained higher and more sustained growth than the West: Japan from the late nineteenth century, Finland and Chile from the early twentieth century, and Singapore from the mid-twentieth century. Other isolated, small economies have done worse than New Zealand, for example Argentina, South Africa, or Iceland until recently. The excuse of isolation and small size is not credible; the record suggests that it is the quality of institutions which societies adopt that matters for long-term growth.

[3] One of the Treasury's priorities in 2001/02 has been working to understand better New Zealand's historical economic performance, and to review its policy settings in order to assess whether there is scope to improve long-run economic growth. This work comes under the umbrella of what the Treasury has called the Economic Transformation project.

Growth and the rules of the game

To answer the questions that the New Zealand experience invites, it is necessary to understand that growth is a complex, microeconomic, organic and evolutionary process. The growth of productivity and incomes is the result of millions of individual decisions to innovate and compete, that is, to incur both the risks and the transaction costs of knowledge search. This is rooted in millions of small changes in individual behaviour towards risk taking, working, saving and exploring new opportunities. A higher aggregate growth rate cannot therefore simply be 'dialled up' by some official reformer in charge of the economy.

The external institutions – the rules of the economic game that are made by governments and formally enforced by coercive means – operate in conjunction with the internal institutions of society in shaping growth. They evolve in the light of experience and incentives which are enforced informally (Kasper and Streit, 1998, chapter 5 and 6; Kasper, 1998, chapter 3). When the internal rules of the game – such as ethical norms, customs, work and trade practices – are not adjusted in response to new legislative and administrative institutions, little sustained change can be expected.

What matters in particular for growth is the attitude to competing and being alert to new opportunities. Economic competition occurs in the first place among suppliers who shoulder what economists call 'the transaction costs of knowledge search': exploring innovative ways of working, producing, investing and forming human capital. This is rarely comfortable, always risky, though sometimes exciting for some. Competitors have to incur exploration costs before they can even know whether the effort is worth the expense. In the literature, this is known as the 'Arrow Paradox' (Kasper and Streit, 1998, pp 54–56; pp 221–226; also Baumol, 2002).

Competition by incurring knowledge-search costs is also necessary among buyers. Where buyers are too lazy to inform themselves and to stay continually on the alert for the best deal and where demanding clients meet with social opprobrium, innovation and growth will remain poor. People who can obtain political protection from competing will, of course, shirk the transaction costs. This is true not only of entrepreneurs but also of managers and workers. Long traditions of protectionism and state welfarism – such as in New Zealand – tend to entrench anti-competitive internal institutions, which top-down economic reforms have to alter if they are to produce sustained growth.

The protagonists of the new institutional growth theory therefore look to factors that might negate the 'traction' of external rule changes on the internal rule system of society. In evaluating reforms, they ask:

1. Are the reformed external rules universal, simple, complete and consistent?

Rules have normative effects on human behaviour if they are certain, stable, general and open – in short 'universal' (Leoni, 1961). 'Universal' means there can be no doubt about the meaning of the rules if they do not change arbitrarily and if they apply to all comparable and all future cases. Cognitive limitations, from which all humans suffer, make it imperative that the rules should be simple, cover all aspects of economic action,

and be consistent among themselves. Thus, for example, a liberal market order will only be effective if free product markets are coupled with free labour and capital markets.

2. Are the economic reforms explicit, transparent, credibly enforced and well explained to the public?

Secret rules cannot be easily known. The regulatory structure must be transparent to citizens to affect behaviour. The same applies to the explanation and credible enforcement of new rules to an often unwilling, uncomprehending public.

3. Is the new legislation well anchored, so that the reformed rules will remain in place?

Learning and cultural changes normally take time. This is so particularly in insular societies with little tradition of dynamic change and cultural flexibility. If there is an expectation that external rule changes will soon be overturned again, the internal rules will not be adjusted, because this inflicts learning costs. New legislation therefore needs to create the expectation that the new rules will last.

4. Are the rules that shape social and political freedom compatible with the new economic rules?

Economic freedom is only one aspect of overall freedom. Social and political freedom is needed to make it fully effective. If cultural norms mitigate against competing, if social welfare provision erodes the incentives for personal responsibility, and if political freedom is lacking, free economic institutions will be less effective. Admittedly, economic freedom can make a difference on its own; it even tends to pave the way to political freedom, as was the case in many parts of Asia and still is in China (Friedman, 1962; 2002).

5. Is the political order supportive of a steady application of the liberalised economic rules over time?

Learning costs and the limitations of human cognition make it necessary for reformed rules to be applied credibly and with a steady hand, with few exceptions and no backtracking. Reversals in external rules make it inevitable that burdensome internal rule changes are avoided. This in turn depends partly on whether the political sub-order is compatible with a free economy.[4]

To some, these questions may seem commonsensical, even banal. However, the extent to which government-decreed liberalisation enhances productivity and incomes in a sustained manner is determined by the answers.

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[4] The literature on institutional economics speaks of an 'order' when it refers to recognisable patterns in a particular field of human interaction. Order may be imposed by a higher authority (for example, on train traffic by a timetable) or may result from spontaneous compliance with given rules (for example, in the case of car traffic in a town).

We speak of the 'social order' when we refer to all fields of human interaction in a community. It is divided into interdependent sub-orders, such as the political, the social and the economic sub-orders. Within these spheres, there are interdependent sub-orders at a lower and more specific level, for example those rule sets that govern labour, capital and product markets.

The above tests focus on the need for economic policy to be guided by the lodestar of economic freedom. In the complex structural changes that liberal reforms engender, in the confusing leads and lags of adjustment and in the contradictions between various arms of government, ordinary human beings benefit from being guided by a steadying and widely recognised lodestar, the principle of freedom that motivates and directs the many members of an evolving community. Once people and the leadership lose sight of this vision, the course becomes erratic and the economy accident-prone.

The remainder of this article is couched in terms of a Report Card which focuses on the total institutional order of New Zealand with the benefit of a vantage point some ten years after governments ceased to pursue significant reforms and followed differing and changing guiding principles.

New Zealand reforms through the institutional looking glass

1. Universal, simple, complete, consistent?

From the viewpoint of institutional design, the New Zealand reformers of the 1980s and early 1990s did the right thing by formally instituting a new framework. With a few exceptions, the key legislation was simple and provided clear and consistent economic rules. It was in accord with the principles of universality. There were several milestones towards a new liberal 'economic constitution'. In 1989, the Reserve Bank of New Zealand was made operationally independent of the elected government of the day and was given a transparent goal of price-level stability. The State Sector Act 1988 and the Public Finance Act 1989 introduced output-based monitoring and clearer responsibilities for public servants. The Employment Contracts Act 1991 enhanced the freedom to work and employ. And the Fiscal Responsibility Act 1994 imposed rules of accountability on government (most notably by requiring all Crown financial reporting to be in accordance with generally accepted accounting principles) which resembled those that government demanded of corporations. In addition, product market liberalisation was to some extent credibly underpinned by rules from the General Agreement on Tariffs and Trade (GATT) and World Trade Organisation (WTO), which make the reversal of tariff cuts difficult, and the Australia and New Zealand Closer Economic Relations and Trade Agreement.

The first wave of reforms in New Zealand in the mid-1980s amounted to partial liberalisation: dramatic steps to free capital and product markets were not matched by reforms to regulated labour markets and socialised welfare (Kasper, 1996, chapter 1). This was done for reasons of political expediency and out of a conviction that an interventionist regulatory system could only be dismantled bit by bit, with further reforms being implemented as political opportunities arose (Douglas, 1990). Such political expediency, which may well have been justified, came at a price: the resulting inconsistency in the overall economic regime led to major distortions in relative prices and much economic pain. The late 1980s were a demonstration of the verity, well known to *ordo* liberals, that inconsistent sub-orders are unstable and hard on competitors and investors.

Following the change of government in late 1990, the centre-right National government engaged in some political entrepreneurship of its own, deregulating labour markets and reining in the burden of government spending. This made the economic order inherently much more consistent again and led to a pick-up in growth and job creation. A further consequence of the transitional inconsistency of the late 1980s was that many New Zealanders began to have second thoughts about the merits of economic reform. Some political elites, who saw their influence dwindle as markets empowered individuals, grasped the opportunity to rid themselves of a political system which had made quick and unanticipated reform possible. The introduction of the 'mixed member proportional' (MMP) electoral system in 1996 made majority government almost impossible and has led to compromises in shaping economic institutions and policies.

The reforms were reflected in the aforementioned Fraser Index. Economic freedom ratings of New Zealand improved strongly from 1985 to 1995. They have subsequently slipped somewhat while some other countries have generally moved ahead (Gwartney and Lawson, 2002, p 18).

In rating the New Zealand reforms on the first criterion (universality, simplicity, completeness and consistency), I would award 60 percent to the first (Labour) wave of reform, and an extra 15 percentage points to the subsequent (National) reforms, yielding a total score of 75 percent.

A 100 percent score would not be justified. Unlike Hong Kong or Singapore, New Zealand has not moved to complete free trade. It has maintained excessive statutory and judge-made labour market regulation, including a minimum wage; there are policy-induced barriers to competition in a number of markets; and New Zealand scores poorly on the Fraser Index (thirty-eighth place) for the size of government. Privatisation is incomplete and further sales of state-owned enterprises have recently been ruled out (Barry, 2002). In addition, the new liberal order would have had more, and more rapid, impact had the reform agenda been supplemented by better and more explicit protection of private property rights from parliamentary opportunism, along the lines of a regulatory constitution as proposed by Richard Epstein (2000). There have been many instances of uncompensated takings, ranging from systematic expropriations under the Resource Management Act 1991 to discrete events such as the National-New Zealand First coalition's forced separation of electricity lines and retailing operations.

2. Explicit and explained?

Both waves of reform were the work of a small group of senior politicians who were supported (for a time) by their cabinet colleagues and were able to carry the legislative changes thanks to party discipline. In the case of the Labour government of prime minister David Lange, who had little taste for economic matters, an unwritten accord seemed in place under which the prime minister would keep out of economic management and the minister of finance, Roger Douglas, would have the latitude to

implement his policies. Under the subsequent National government, economic liberals around Ruth Richardson as finance minister had a similar window of opportunity to reform, despite a conservative party core. However, in both cases the reformist ministers were sacked or resigned when their party leaders, influenced by party and public criticism, lost all appetite for reform.

The reforms, widely admired for their speed, did not always have to undergo the arduous tempering of intensive public debate. The changes were not explained as well to the public as similar reforms were before they were implemented in different political systems. While Roger Douglas and, to a lesser extent, Ruth Richardson made admirable efforts, they had little help from their respective prime ministers. Thanks to New Zealand's pragmatic, if not even anti-intellectual, political culture, the centrality of secure property rights and free contracting was not sufficiently explained to the citizens. Abstract concepts such as economic freedom were rarely debated. Consequently, popular attitudes and the internal institutions of New Zealand society were not reshaped sufficiently fast to entrench rapid growth. There was no Margaret Thatcher, Ronald Reagan or Ludwig Erhard who repeated the simple, basic principles of economic freedom again and again.

In rating the New Zealand reforms for explicitness and transparency, I would award a score of 60 percent.

3. Stable and predictable?

A progression of external rule systems in the direction of more freedom can be absorbed by entrepreneurs, but not institutional zigzags. Initially, there was – as noted – inconsistency between institutions. Later, the rules became unstable over time, not least because the judiciary counteracted the spirit of reform, particularly in administering employment law, and because political leaders saw mileage in distancing themselves from the liberal vision. Another case in point is the "stop-start record of privatisation in New Zealand [and the fact that] … New Zealand is now lagging in international best practice in several important areas" (Barry, 2002, p 42). The partial renationalisation of the national 'flag carrier' Air New Zealand – an outdated concept of economic nationalism – is just one example of policy inconstancy. Such zigzags signal to investors and citizens that New Zealand economic reformers have lost sight of the guiding lodestar of economic freedom. This is invariably costly in terms of trust, effective coordination and, hence, economic growth.

This pattern is of course not unique to New Zealand. We have observed similar and costly institutional flip-flops in Eastern Europe, Russia, Latin America and elsewhere. These experiences and Britain's post-war nationalisation, denationalisation and renationalisation of certain industries and banks show how costly such changes in direction tend to be in terms of economic growth.

What is fairly unique to New Zealand is a simple structure of government, which allows a slim parliamentary majority of the day to overturn fundamental constitutional rules. New Zealand's order lacks the usual checks and balances that normally act as stabilisers

which make it hard to change high-order rules in haste – for example, a written constitution, a multicameral parliament, a stricter division of powers than in the Westminster system, federalism, and an assertive constitutional court (Ratnapala, 2002). In most countries, fundamental rules of coordinating economic life – rules of constitutional quality such as the Employment Contracts Act 1991 – are altered only after intensive discourse and critical scrutiny as to whether there is strong and irresistible evidence for change. High-order constitutional rules provide restraints that sometimes protect us from our opportunistic selves. When a country embarks on reform, the going during the transition can get tough. It is then tempting to bail out. Constitutional safeguards can protect the long-term course from the political opportunism that seeks to avoid short-term pain.

Wilkinson (2001) emphasises the problems of a weak 'constitutional attitude' in New Zealand. The absence of constitutional stabilisers made it easier to implement far-reaching reforms and to avoid the costs of time-consuming public debates. To make risky, arbitrary changes less likely in future, quasi-constitutional instruments, such as the Reserve Bank of New Zealand Act 1989 and the Fiscal Responsibility Act 1994, were enacted as part of the reform programme. But when a simple majority or a group of dedicated activists can rewrite the rulebook for the next game with relative ease, the reengineered rules 'connect' only superficially with the internal institutions that matter for sustained growth. The clutch that connects external and internal rule systems is then slipping, so to speak.

New Zealand's lack of constitutional stabilisers had probably gone unnoticed when policy was conducted within a corset of dense regulation. However, with globalisation, accelerating technical change and the cross-currents of freed-up markets, the lack of a 'constitutional backbone' contributed to a loss of trust. Fundamental rule reversals – such as the deregulation of the labour market in 1991 and its reregulation in 2000 (Kasper, 1996; 2000) – confuse the long-range plans of entrepreneurs and thus depress growth. Equally importantly, when a small, peripheral economy such as New Zealand, which might be fortunate to get five minutes of a chief executive officer's attention in New York a year, displays such constitutional inconstancy, international investment is discouraged. The response of the Labour-Alliance government treasurer, Michael Cullen, to criticism of institutional reversals – "We won, you lost. Eat it!" – reveals a total lack of understanding of the fundamental importance of institutional stability.

A less changeable and more consistent order would thus have been more effective and stable in raising economic welfare and fostering the enterprising, competitive attitudes that are the very basis of economic growth.

In rating the New Zealand reforms for steadiness and predictability, I would therefore award a mark of no more than 40 percent.

4. Compatibility with social welfare?

The new economic rules were not accompanied by corresponding reforms of socialised welfare and, hence, a sufficient reduction in the size of government. The long New

Zealand tradition of the state as a corrector of market outcomes and a provider of cradle-to-grave social security continued. Some changes were made to retirement income and welfare programmes, but total expenditure on social welfare as a proportion of national income has increased. The share of government consumption in the national product and the ratio of transfers to it are significantly higher than in Australia.

In New Zealand, many still seem to adhere to what might be called the 'Millsian fallacy' – the notion, propounded by John S Mill, that the price mechanism could efficiently allocate scarce resources while, at the same time, the visible hand of government 'corrects' income distribution. Allocation and distribution are not two separate things. In reality, market signals steer allocation, and the pursuit of useful knowledge according to people's preferences, productively and effectively only because differential incomes generate price incentives (Friedman, 1962, pp 161–176; 1980, pp 159–182). Differential market outcomes may appear unfair to some outside observers, but they provide the incentive to produce what others want most urgently. Of course, politicians and interventionist economists thrive by appealing to a perceived lack of fairness (envy), but the redistribution that they advocate makes market coordination dysfunctional. Coercive redistribution is therefore invariably at the expense of growth. The argument that gross income differences lead to social conflict and crime, and that this in turn detracts from growth, does not turn this fundamental insight on its head in developed, well-governed communities. New Zealand does not have large income disparities even though there has been some widening of the income distribution – especially at the top end – in line with international trends that reflect a greater market premium on high skills in an era of globalisation.

Social welfare provision and redistribution, which typically is not from rich to poor but from unorganised to well-organised groups, thus has pervasive effects on how people respond to new external rules. The Labour-Alliance government's moves on tertiary education, superannuation and paid parental leave have favoured the better off. The incentives for household saving, which is quite low in New Zealand, would have been enhanced by a reprivatisation of welfare, in particular of education, health and retirement income provision (Cox, 2001). Genuine social reforms would have brought the attitudes of New Zealanders to work, service, shouldering knowledge-search costs and self-reliance more in line with the norms prevailing in the United States, Australia or Asia. Individual responses to the new labour-market incentives and in daily life would have been more entrepreneurial, immediate and pervasive.

In rating the New Zealand reforms for compatibility of economic freedom, social institutions and self-responsibility, I would therefore award only a score of 50 percent.

To be quite explicit: the trade-off between socialised welfare and growth is a statement in *positive* economics. Public welfare influences millions of choices by individuals to compete and save, and, hence, the aggregate growth rate. The observation is not meant as a *normative* statement – an outside observer telling New Zealanders that they ought to compete harder or aspire to more rapid growth.[5]

[5] Positive economics is concerned with what is or will be, that is, a description of events and developments without reference to value judgments. Normative economics is concerned with value judgments, with what is good or bad, or ought to be, that is, matters about which there can be legitimate differences of opinion.

5. Consistency with political rules and steadiness over time?

The 1990s also showed up another major problem of system inconsistency. While the economic sub-order in New Zealand became more universal – indeed more so than in most other affluent countries – the political sub-order remained inconsistent with a free and open economy. In some respects, it was even made less consistent, so that New Zealand's entire rule system became less stable and less confidence-inspiring. The electoral rules were changed when the political class, including many academics and union leaders, discovered that the free-market reforms had shifted some influence away from them and empowered individuals and firms. In the wake of the lopsided liberalisation of the 1980s, self-doubts on the part of many voters about the merits of competing gave the *classe politique* the chance to convince voters to adopt the MMP system and to promote other reversals to liberalisation.

Political experimentation since the election of the Labour-Alliance government in late 1999 has overturned elements of past liberal reform. This now confuses the fundamental institutional setting of the New Zealand economy in several areas. The reactionary policy drift back to 'mandate, regulate, litigate and collectivise', to the detriment of relying on the spontaneous market order, began with the increase in the personal income tax rate, the monopolisation of accident insurance, and the reregulation of labour markets (on the latter, see Kasper, 2000). Subsequently, the government created a retail bank, partly renationalised the major airline and reduced competitive disciplines on public services (OECD, 2002). Earlier social and environmental activism (reflected, for example, in the New Zealand Bill of Rights Act 1990, the Resource Management Act 1991, the Human Rights Act 1993 and the Privacy Act 1993) created the impression that New Zealand was following the increasingly uncompetitive, collectivist, top-down 'European style of governance' and sharing in what has been called the 'New Millennium Collectivism' of the European Union (EU), the United Nations (UN) and many single-issue non-government organisations (NGOs).[6]

The European style of governance is increasingly becoming 'post-democratic', as elected national parliaments, which obstinately continue to object to supra-national causes, allow international conventions that further such causes to be adopted. They permit their former powers to be exercised by unelected bureaucracies in the UN or the EU Commission. In a number of areas, they have shifted a large measure of national sovereignty and democratic accountability to remote bureaucracies. The European social-democrat regimes are today attracting little foreign investment relative to their competitors, and are not exactly brimming with small-scale enterprise. They contrast with the British-American individualistic-competitive tradition where voter-controlled parliaments still exercise a real influence over policy settings. New Zealand is not in northwest Europe, and its institutions are measured against the standards of the Asia-Pacific where the American and Australian style of parliamentary democracy and shirtsleeve competitiveness prevail. New Zealand's centre-right governments of the 1990s, as well as the centre-left ones that have followed, abandoned the competitive, liberal vision and drifted back to collectivism and a belief in the visible hand. The loss

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[6] See David Henderson (2001), *Anti-Liberalism 2000*: *The Rise of New Millennium Collectivism*, Thirtieth Wincott Lecture, Institute of Economic Affairs, London.

of a guiding and coordinating liberal vision has also affected the judiciary, whose economic literacy appears limited and which focuses excessively on ill-defined notions of fairness of perceived outcomes, rather than the application of the law.

It is indicative of the fluid constitutional situation that in the election campaign of 2002, a few speeches by leading Labour politicians blaming poor growth on the allegedly restrictive policies of the Reserve Bank of New Zealand appear to have been sufficient to raise doubts as to whether the Reserve Bank's operational independence would survive in its present form.[7] Where essential constitutional rules, such as central-bank independence, are better 'anchored', mere political utterances alone could not destroy trust in their stability. In the aftermath of the election, the Reserve Bank Policy Targets Agreement was modified by the government, the third modification in six years – not a sign of a steady hand and a stable rule system.

New Zealand's political constitution exposes the country's good economic ground rules to an extraordinary degree to the winds of electoral and political whim. It is not surprising that surveys show that New Zealand governments are rated poorly when it comes to honouring the commitments of previous governments (World Economic Forum, 2002).

To a mind trained in constitutional economics, New Zealand looks like a person who has cast the crutches of artificial regulation aside but discovers that they lack a constitutional backbone strong enough for running. Alas, it is immensely hard to strengthen a weak backbone.

In rating the New Zealand reforms for the criterion of political support for a steady application of the external rules over time, I would therefore award only a 60 percent score, and one that is now trending downward.

Competition can self-destruct, as evidenced by many cases in history in which governments failed to defend the principle of free, self-reliant competition, or in which social barriers to competing and exploring new ideas led to stagnation. Latin America's many aborted episodes of liberal reform, followed by short spurts of growth, come to mind. Without comprehensive changes in the entire set of institutions, history has a tendency to reassert itself and political failure can then easily frustrate the quest for growth. One cannot, therefore, be confident that the New Zealand episode of 1984 to 1994 will not look – from a historical perspective – just like another such interlude.

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7 The allegation that monetary policy frustrates economic growth seems based on confusion between long-term growth, a supply-side phenomenon, and short-term demand expansion. Unexpected inflation may act like a heroin shot that boosts aggregate spending for a while, but the medicine is addictive and soon introduces distortions that confound investors and suppliers and hence destroy growth. The Keynesian theory that boosting demand can produce *sustained* growth has been discredited most recently by Japanese attempts to boost demand by expansionary monetary policy and no less than US$1.1 trillion in fiscal packages over the past 15 years. This massive demand injection only produced growing unemployment, rising indebtedness, weak banks and plummeting credit ratings, because it came without the institutional reforms to make Japan's supply apparatus more elastic.

In the case of New Zealand, 'access to sound money' – a key condition for economic freedom and growth – has recently been downgraded. New Zealand is now ranked only forty-second among 123 countries (Gwartney and Lawson, 2002, p 14).

Many New Zealanders seem to sense the problem of insufficient 'anchoring' and political zigzags and are searching for *ersatz* stabilisers, for example a currency board with the Australian or US dollar, or even joining the Australian federation. As Argentina's dollar–peso link has demonstrated yet again, currency boards are escapist props and poor substitutes for a country designing a sound, stable system of its own. A tie-up with an ailing, non-competitive New Zealand would not find much favour in Australia; taxpayers would hardly welcome a replication of Tasmania's economic woes and the burdens it imposes on most of them (Rae, 2002).

Summary Report Card on the New Zealand reforms 1984–1994

1. Completeness and consistency	60 > 75%
2. Explicitness and transparency	60%
3. Stability and predictability	40%
4. Compatibility with social welfare	50%
5. Steadiness of application	60 > 50%
Overall performance, with equal weight for each factor: a mere 'Pass'	54–55%

Putting the reform experience into perspective

The economic reforms were perceived in New Zealand as dramatic by the standard of the country's heavily regulated past. Indeed, they gave New Zealand excellent ratings in the usual international surveys of economic freedom, such as the Fraser Institute Index. However, recording a certain level of economic freedom is one thing, and the tactics by which it is brought about are another. On that score and when one takes social and political aspects into account, as was done above, the overall Report Card on the economic reforms comes out as a mere 'Pass'. In all likelihood, more consistent reform would have raised the growth rate over and above the creditable 3.3 percent per annum that was achieved from 1993 to 2002 (International Monetary Fund, 2001).

The correlation of international comparisons of economic freedom indexes with economic growth rates tells a compelling story. However, New Zealand has consistently shown up as a country with less growth than its freedom rankings might lead one to expect. Free institutions are of course not the only determinant of growth. Nor is the average index of economic freedom everything, even if we disregard measurement problems. Fundamental social attitudes matter, and these tend to be sluggish variables. Are New Zealanders as 'hungry for growth' as people in similarly free societies in the Asia-Pacific region? Are they as committed to cultivating a free-market economy as their competitors? Do they have a consistent history of free markets and capitalist enterprise? The tactics of getting to the present level of economic freedom, the inconsistencies across the various components of the index, and incompatibilities between economic freedom and social attitudes are bound to impact on a country's actual growth rate, so that the New Zealand deviation can certainly not be taken as invalidating institutional growth theory.

It seems, at least to this observer, that a comparison with Australia, a more enterprising and less regulated economy to start with and one with a broader endowment of growth assets, is instructive:

- Australian reforms have, by 2002, been somewhat more complete and consistent (meriting, say, a rating of 80 percent compared with New Zealand's 60 to 75 percent).
- On explicitness and transparency, I would award Australia the same score as New Zealand (60 percent).
- Australia's reforms proceeded more slowly, accompanied by more thorough and open public debate, making the reforms when they were adopted much more predictable than in New Zealand (my subjective score: 70 percent).
- Social attitudes to competing are more pronounced in Australia, especially away from the old rust-belt regions that once attracted British migrants with a non-competitive culture who benefited from subsidised passages. Australia's social policies have stressed self-reliance and welfare reform more than has been the case in New Zealand, so that a rating of 60 percent seems justified.
- Reforms have been more steadily applied than in New Zealand, meriting a score of, say, 70 percent (despite the fact that some states have, in recent years, counteracted the steady move to more economic freedom).

One should of course beware of placing too much store in such subjective rating schemes. Nevertheless, Australia's reform Report Card for 1980 to 2002 would show a 68 percent ('Credit') score. This seems compatible with Australia's recent track record of resilient growth (4.1 percent a year on average in the decade to 2002 (International Monetary Fund, 2001) and its move up the international per capita income scales, as well as its position in the top half of the OECD income range. While the New Zealand economy has grown markedly less fast than its excellent freedom rating would indicate, Australia's economy has grown by around the rate that international correlations between economic freedom and growth predict (Gwartney and Lawson, 2002).

There is, however, no fundamental reason why the New Zealand economy could not equal or even surpass Australia's growth performance.

The major lessons for those who seek economic reform may not be big news for those steeped in *ordo* liberal economics, but they are nonetheless worth recording. One lesson is that economic freedom cannot be considered on its own. A comprehensive approach to reform requires the political and social sub-orders to be taken into account. Another lesson is that changed external rules of the economic game often take a long time to affect economic behaviour and the population's fundamental values. This is especially true when the change comes after an experience with different rules, and when openness allows the young, the ambitious and the impatient to emigrate to economic climates that are more to their liking. Both these conditions apply in New Zealand. Somewhat more impressive growth benefits may yet materialise if policy makers and voters can control their opportunistic instincts and keep a steadier hand on the tiller.

One could also deduce from the New Zealand experience that comprehensive economic reform in as little as a decade may be less of a role model for others than more gradual, but persistent reform. Gradualism – as practised, for example, in Australia – favours the slow learners. However, a gradual strategy is less feasible when a country is facing an economic crisis, as New Zealand did in 1984. Also, with gradualism, opponents of reform are given time to regroup and strike back. Ultimately, academic theorising about optimal reform paths may be utopian, as political reality often does not leave many choices (Douglas, 1990). In any event, institutional reform is never easy, and it requires a mature, economically literate public. Unfortunately, economic literacy and political maturity are casualties of political mollycoddling and interventionism.

Good policies *versus* good rules: Can government do anything to promote growth?

Is the creation of enterprise- and growth-friendly institutions all that needs to be done? Is there *no* room for informed government intervention to promote economic growth?

Essentially, the government's role in fostering growth is indeed to provide and credibly enforce innovation- and enterprise-friendly rules. This is how governments compete internationally in the era of globalisation. It is also what Aristotle advocated when he asked whether the community's welfare should be entrusted to good men or good laws. Good men, he said, when they intervene with political means, simply lack the capacity to know the consequences. Cognitive limitations are certainly dominant when we deal with policies that affect a complex, ever-evolving economy. Who can know the long-term side effects of specific actions and know whether they help or hinder? These limitations are real, as the history of industrial policies to 'pick winners' amply demonstrates. Besides, self-seeking reelection motives on the part of political parties all too often overshadow rational economic considerations in public choices (Burton, 1983; Kasper, 1985).

A possible and temporary exception to this general rule was underdeveloped East Asia. In Japan in the 1950s and early 1960s, and in the four 'Tiger economies' of the 1960s and their imitators subsequently, bureaucrats were able to pick winners, initially with some apparent success. They simply copied what had been successful in countries higher up the development ladder and what could be imitated with low wage rates, hard work and tax exemptions. Over the longer term, this sort of industrial policy led to *sclerosis nipponica*, crony capitalism and corrupt corporate governance (Kasper, 1994; 2002). The proliferation of imitative industry policies has also led to excess capacities and profit compression in supposed 'winner industries'. It is therefore inconceivable that a highly developed, relatively high-income country like New Zealand could benefit from selective industry policies.

There seems, however, some room for *generic* supply-side policies to assist with mobilising human and financial capital, knowledge, land and natural resources. These can take the form of removing unjustified barriers to entrepreneurial activity, lowering tax burdens, providing information (for example, on land title) and fostering high

education standards. Governments can also facilitate the private supply of productive infrastructures, especially those that reduce transport and information costs, and tax and social welfare policies could be made much more favourable to growth.

Conclusion: How badly do you want the economy to grow?

Recent official growth projections see the New Zealand economy growing by barely more than 2 percent per annum in the medium term, that is, less than what has been realised over the past ten years. This would seem realistic if the government envisages ongoing redistributionist and protective interventionism. However, some New Zealanders seem to aspire to at least twice that growth rate and want to lift the country into the top half of the OECD income league.

Competing in the open global economy and at home is rewarding in terms of growth, job creation, life opportunities, longevity and social optimism. But rapid growth is not cost-free. It requires the present generation to make the 'savings sacrifice', forgoing present satisfaction to accumulate human, financial and physical capital. It challenges comfortable and familiar ways, as well as established power structures, and it requires structural changes and a willingness to accept the costs and risks of exploring new ideas.

The choice between community-wide competition and fast growth on the one hand, and the protection of a more familiar, seemingly more secure life with modest prosperity on the other, is a matter of *normative* economics. It must be left to informed political decisions, ultimately by the voters. It is legitimate for an electorate to opt for low growth, as Tibet did for a long time before the Chinese takeover, or the Middle East and Tasmania are doing. In the final analysis, one has to respect popular sovereignty and accept that the New Zealand electorate might prefer protection and copious redistribution combined with slow economic growth. All that *positive* economic analysis can contribute to the debate is to insist that a community cannot have, for long, both redistributive interventionism *and* rapid growth.

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