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No More Free Beer Tomorrow? Economic policy and outcomes in Australia and New Zealand 1984-2003

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1. Introduction

There are no controlled experiments in macroeconomic policy, or in systematic programs of microeconomic reform. Governments adopt policy changes in response to economic challenges and to the perceived inadequacies of past policies. Hence, it is usually difficult, even impossible, to make definite connections between policies and outcomes.

One of the closest approaches to a natural experiment comes about when countries with similar histories and policy problems adopt different responses for identifiable contingent reasons. Dramatic examples are provided by the contrasting experiences of East and West Germany, or of North and South Korea.

Although the differences between them are less dramatic, Australia and New Zealand provide similar opportunities for comparison on a number of policy issues from race relations to bicameralism. Economic policy is another striking example. Facing similar circumstances in the early 1980s, and with the same general set of policy options, governments in the two countries took significantly different approaches to the selection and implementation of reform options. Australia took a path of gradualism and consensus while New Zealand policymakers 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 chapter, 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), Quiggin (1996), Hazledine (1998), Quiggin (1996)), 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 chapter is organised as follows. Section 2 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. Section 3 focuses on New Zealand's poor performance, with Australia in the role of an experimental control. Section 4 deals with the outlook for the future, and suggests that both countries are moving towards a pragmatic managerial model, in which a variety of market-based instruments are used to operate what is still, in essence, a social-democratic system. Finally, some conclusions are offered and implications for globalisation are discussed.

2. Convergence and divergence

For most of the 20th 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 in both countries the policy failures of the Depression years, leading to the election of Labour governments (we will use the NZ spelling throughout to refer to both the New Zealand Labour Party and the Australian Labor Party) which expanded and modernised the welfare state during, and immediately after the war years (Savage in NZ and Curtin-Chifley in Australia)

In both countries a long period of postwar political dominance by the conservative parties was interrupted by the election in 1972 of Labour governments, both 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 postwar period, they were criticised in retrospect for having missed an opportunity to undertake more extensive, and more market-oriented reforms.

Despite this somewhat anachronistic criticism, the general policy tendency of both the Muldoon and Fraser administrations was actually towards economic liberalisation. 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 of 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 consistently 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 the Australian Prime Minister Bob Hawke to a policy of bargained consensus. Reflecting his long period as President of the Australian Council of Trade Unions, Hawke focused on bargaining between governments, union bodies and employers. Other interest groups, for example those representing the welfare sector, were allocated a secondary role.

Hawke's focus on consensus moderated the push for reform in two main ways. First, where policies failed to gain support, or at least acquiescence, from business and unions, they were usually not pursued. For example, proposals for a Goods and Services Tax, put forward in Hawke's first term in office, were abandoned when a Tax Summit, bringing together major groups, failed to achieve agreement on the proposal (despite an agenda designed to ensure that this was the only possible outcome).

Equally significantly, 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. The most important was the Prices and Incomes Accord. Originally designed to be a tripartite agreement, it failed to secure the support of employers and became a bilateral agreement between the government and the ACTU, focusing almost exclusively on wages and on the provision of various policy concessions in return for sustained moderation in real wages.

Another important instance of the consensus approach was the development of Industry Plans for sectors of the economy faced with import competition as tariffs and quotas were scaled down. The most important examples were for steel, motor vehicles and textiles, clothing and footwear. Opinion remains divided regarding the substantive merit of the planning process, but it is clear that it faciliated a gradual reduction in tariff and quota protection, while precluding radical reductions.

The consensus approach was consistent with the relative weakness of the central government in a federal system with bicameral parliaments and a powerful and well-organised union movement. Even administrations inclined to a more radical approach, such as the Whitlam government, have found it very difficult to drive through rapid change in such a system.

By contrast, the New Zealand Labour government adopted a radical approach. Although he adopted a rhetorical focus on consensus similar to that of Hawke, Prime Minister David Lange focused his own attentions mainly on social and foreign policy issues, leaving economic policy to his Finance Minister, Roger Douglas. Douglas, supported by like-minded junior ministers, and an ideologically united economic policy community encompassing Treasury, the Reserve Bank and the powerful big-business lobby group the NZ Business Roundtable, 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 PM 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.

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 per cent to 39 per cent 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 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 20th century, income per person in New Zealand grew in parallel with Australia. In the 1960s and 70s 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 in after 1973, with falls in export commodity prices and the accession of the UK to the European Union. Figure 1 (which updates the data in Dalziel, 2002) shows the effects of both these shocks on the ratio of Australia to New Zealand GDP per capita, but even so, in 1983, on the eve of the NZ policy revolution, the gap was only 5% in the larger country's favour.

The next seventeen years were a period of almost unremitting deterioration -- from New Zealand's perspective -- 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. In international comparative terms, the widening gap is partly due to Australia doing quite well, but mostly to NZ's growth performance up to 2000 ranking bottom -- 26th out of twenty six! -- in the OECD (Hazledine, 2003). Since the turn of the century, NZ'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 ever 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 as whole.

3. New Zealand: what happened?

It seems that New Zealand had the 'best' set of economic policies and the worst set of economic outcomes in the OECD over the past twenty 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 neoliberal plan, with Australia and its less radical reforms and much more successful growth path cast as a possible counterfactual.

(a) 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) 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 Their implied counterfactual is continuation of the old ‘Albania of the South Pacific’ regime, to eventually founder under its inherent rigidities and contradictions, *a la* Cuba, North Korea or indeed the real Albania. Such has been offered even in competent technical analyses, such as Bollard *et al* (1996, p 23):

> 'New Zealand's economic reform process may still rank as one of the more successful by world standards, with the potential [*sic*] to improve economic wellbeing compared to the outcomes *from an unreformed economy*.' [emphasis added]

But this is a straw man, for three 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 which have always been much more 'liberal' than the arrangements in place at the U.S, border, for example), the abolition of compulsory unionism, and the deregulation of internal freight transportation. The sensible counterfactual to Rogernomics is continuation of gradualist reform, not stasis.

And, third, 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.

(b) You wouldn't want to start from there

Although their extent may have been exaggerated in retrospect, and although their continuation is not a reasonable historical counterfactual to the reforms, it is true that New Zealand before "rogernomics" was an economy unusually bound and restricted by regulation -- more so than Australia. 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. The argument, or assertion, as paraphrased by Easton and Gerritsen (1996, p43) is that 'New Zealand, as a result of Muldoon's interventions, was much worse placed than Australia in the early 1980s.'

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 NZ (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 is an economy from its potential frontier, the faster it should grow towards that frontier when the restrictions are removed.

(c) Free Beer Tomorrow!

Enthusiasts for the reforms have for some time been promising that success is just around the corner. Indeed, such soothing prophesying goes back quite a long way, to Roger Douglas's 1986 budget speech, in which he promised that the economy was now firmly on the path of 'sustainable supply side growth.' 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.

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 1993-4, these authors concluded that NZ 'is on a trajectory to maintain its economy as a consistent high performer among the OECD' (p1895, quoted in Dalziel, 2002, p 33). Unfortunately, growth fell every year after that for four years, and the 93-94 spurt looks now than 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 NZ'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 near-4%. This has enabled one of the most persistent proponents of hard-right policies, Roger Kerr of the NZ Business Roundtable, to claim that:

> 'Those who argued for the reforms have been proved right and their critics have been proved wrong.' (R Kerr, 'No time to stop and smell the roses', *NZ Herald*, 21/05/2005)

An alternative interpretation of the same figures might be:

> *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 NZ'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 -- basically, interpreting the decline in policy radicalism after 1991 to a failure of resolve, not 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 indeed performing poorly (eg 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 in the *NZ Herald* 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…'

Whine, whine. The facts are that New Zealanders are not particularly heavily taxed[1], 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

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[1] OECD studies reported by Brian Gaynor, *NZ Herald,* March 19. 2005.

lists of openness and business-friendliness.[2] Could it be that the problem is too much of these policies, not too little?

(d) 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 *et al* between 1984 and 1991, 65 were completed or well underway by the end of 1988.[3] Presumably this could only have been achieved politically in New Zealand's 'elected dictatorship' system -- unicameral, first-past-the-post, no provincial or state governments -- but even so the single-mindedness of the reformers was impressive. Treasury, in particular, though a great proponent of the doctrine of 'contestability' everywhere else in the economy and indeed society, did a very good job in suppressing any competition in its own sphere of activity -- the provision of economic policy advice -- slashing the funding of the independent NZ Institute of Economic Research and systematically stamping out the capabilities of other government departments to undertake policy research.

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[2] reference Economist and other surveys

[3] Some of these 65 being whole reform programs in themselves -- for example 'corporatisation of 24 state owned enterprises' (one item), and 'full or

Why so fast? At the time, the government claimed the *force majeure* of macroeconomic 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, pp 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 (Rankin, 1995; Kelsey 1997). Other sudden shocks to the system may have been traumatic rather than stimulating.

Related to the speed of reform issue is their sequencing, on which many economists and others who broadly support the NZ reforms (such as *The Economist* magazine) have expressed concerns. If we take the four main sectors of economic activity as being financial markets, goods markets, the labour market, and the public sector, then a fairly orthodox program -- at least amongst those who support a more gradualist rather than 'big-bang' overall approach to reform -- would go something as follows. First 'deregulate' your labour market to make it more 'flexible' so firms are better able to respond to 'shocks' (the terms in quotes are the jargon used in the 'reform' literature -- some may read them as euphemisms).

Then, with a flexible labour force and other impediments to productive efficiency removed, your firms -- especially in the

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partial privatisation of ..[long list follows]' , another single item on the list.

tradeables sector -- will be strong enough to withstand opening up of the goods (and service) markets to international competition, by means of unilateral tariff cuts and elimination of non-tariff barriers. And only then, with open markets and trade well established, are all the stabilising controls on financial and foreign exchange markets to be lifted. Throughout the process, the government should be working hard to get its own house in order, by overhauling its own operations in the name of efficiency, and reducing the public sector deficit with its implications for interest rates and macro stability.

The NZ reform program was implemented in almost exactly the opposite order. Restrictions on capital flows were lifted, the exchange rate floated, and various other financial market rules abolished first and quickly. Then the goods market was liberalised. The two Labour governments of 1984-90 largely eft the labour market alone, perhaps too squeamish to commit the final betrayal of their traditional supporters, the union movement. It was given to the incoming National government to implement, as the last of the major reforms, the 1991 Employment Contracts Act, which was perhaps the most vicious piece of anti-union legislation ever enacted in a democracy.

Even at the time, moderate supporters of the reforms worried about the sequencing issue (eg Blyth, 1987), and it seems likely that premature opening up of financial and exchange markets 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 threse over the 1988-91 period.

(e) 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.
>
> (Colin James: ***Seeking value in the state*,** NZ Herald, March 23, 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 forever -- 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 (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 NZ) are a very long way away from their trading partners.[4] *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. And, indeed, the economic cost of distance has fallen quite sharply, in particular with the innovation of containerisation, the introduction of jet air travel, and the IT communications revolution. Distance should have been a factor operating in NZ's favour over the past twenty or so years, not necessarily relative to Australia, but certainly relative to the other OECD countries whose growth rates exceeded New Zealand's

[4] Apparently New Zealand is the most 'distant' economy on earth, as measured by the trade-weighted distance between that country and its trading partners

What about economies of scale? NZ'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 impact on GDP and which therefore affect short to medium term measurement of economic growth are supply shocks (eg from the weather), and international demand shocks. Both countries have had some problems with droughts; perhaps Australia's have been more frequent and newsworthy. As for demand shocks, these are usually picked up in the terms of trade(ToT) index, which is the ratio of the prices received for exports to the prices paid for imports. A high value is good news, because it means that the purchasing power of a country's exports in terms of the things it swaps the exports for -- ie, imports -- has gone up.

If we scale both countries' ToT indices to equal 100 in 1984, and extend Paul Dalziel's IFS data, we find that the average annual value of the index for the twenty 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. The difference is actually very significant in economic terms, amounting, for a country whose exports and imports are around one quarter of total GDP, to a windfall to New Zealand relative to Australia worth about 5% of GDP each year. This makes the shortfall in New Zealand's GDP performance look even worse.

(f) Wrong Model

(Hazledine and Lipanovic, 2004)

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 they are in fact rather more interesting than that. Even very up-to-date texts in microeconomics and industrial organisation lack an integrated treatment of the post-neoclassical concepts that guided the NZ 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 in fact been fully worked out.

The goal of the reform program was not novel – indeed, it can be seen as rather old fashioned – 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, Grimes and Wilkinson (1996)). This is efficiency in its orthodox welfare economics sense of the aligning of marginal costs and benefits of activities

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 – to 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 their own objectives); (3) because of costly (private) information, P cannot easily verify A's actions (or type).

In the case of the NZ public sector, which was run on civil service departmental lines before 1985, the first job was to establish the primacy of the principal (the revolutionaries), and then to set up the incentive and governance systems to bring the agents' behaviour into line with the principal's efficiency objective. The underlying assumptions were that public administration had been basically captured by the agents – the civil servants – who would wish to follow goals other than (or at least supplementary to) narrow efficiency, and who would have the power to do this as a result of their private information. As reported by Duncan (1996) 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.' (p397)

That is, if the market can exercise the efficiency control function, then privatise (eg, telecoms, rail and air transport, forests, banking, etc, etc). If ownership of a basically commercial function is to remain with the state, then 'corporatise' it, meaning instruct the managers to operate on commercial criteria (post, broadcasting). If the duties of the department are inherently uncommercial (in whole or in part), then specify quantifiable 'outputs' as targets and establish systems of accountability to give managers the incentives to achieve these goals (health, education, research, etc).

These principles of Agency Theory were applied at the very highest level, to the politicians themselves. The Minister of Finance 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.[5] But perhaps the most striking example of the application of agency theory is to 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 potential remuneration of the Governor of the Reserve Bank apparently depends on his success in achieving this goal, such that in one particularly low-inflation year in the 1990s then Governor Brash's total pay exceeded that of the Governor of the US Federal Reserve Board, Mr Greenspan.

It is fair to say that the Fiscal Responsibility Act is generally seen as a success, but that monetary policy remains controversial. The latter can indeed be taken as a 'textbook' 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[6]; (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 zero-to-two percent. Rather than fire the Governor (or require him to pay back some of his performance bonuses from previous years), the Minister of Finance meekly extended the upper limit to three percent.

As for the private sector (including the privatised elements of the old public sector), the revolutionaries here placed great faith in

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[5] So that, for example, the government can no longer slip the proceeds of asset sales into their current revenues so as to appear to reduce an operating deficit.

[6] The Bank was allowed to define its own output measure, which it called 'underlying inflation' (excluding, notably, interest rates), rather than be judged on actual inflation, which it pejoratively termed 'headline' inflation, and which sometimes moved outside the target band.

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 Agency Theory's close cousin 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, p131))

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'-- rent-seeking, impediments to free competition, crowding-out of private sector investments, and so on. The fear of government failure was taken to extremes not seen in other market economies. The newly privatised network industries -- incumbent monopolies and all -- were 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'.

Superficially, there may seem to be a dichotomy between the highly intrusive control systems imposed on the surviving public sector and the laissez-faire attitude to private sector activities. But from an agency perspective there was indeed a unity in approach. The common idea is to induce agents to achieve narrowly specified performance targets (these being commercial or profit targets where possible). This can be effected directly through the design of agents' (public sector managers) remuneration contracts, or it can be done indirectly through market forces – basically by establishing a 'contestable' market environment in which non-commercial behaviour becomes costly (because it will attract competition).

In the latter case, the actual mechanisms for achieving the targets are left to the private sector to discover for themselves, but – if Agency Theory holds generally – these mechanisms will be basically the same: incentive/penalty schemes to give the agents who operate the private sector organisations the motivation to align their own behaviour with the objective of (commercial) success. If so, then we would expect to observe a shift in resources towards monitoring activities, or ‘managerialism’ in general, across both public and private sectors.

Hazledine (2001) tested this prediction, applying the pioneering US research of Wallis and North (1986) to Australian and New Zealand data. Wallis and North distinguish the '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 our complex modern production systems operating. Hazledine found that (as in the US), the share of GDP taken up by the transaction sectors of Australia and New Zealand has increased over time (to more than 40%), but that, notably, transaction sector growth over the past twenty years was higher in NZ, with almost all the difference accounted for by what amounts to an explosion in the number of managers in private and public sector New Zealand, such that, of every twenty workers, one who in Australia would be in the transformation sector actually making stuff would in New Zealand be a manager supervising other people producing goods and services.

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? Specifically, what if its basic premise of the pervasiveness of 'selfish shits' (rational opportunistic individualists) is a distorted vision of how modern societies, including their economies, actually function, because it first 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.

It is very tempting to apply agency theory to the principals themselves. Why should we not assume that the proponents of the NZ reforms were themselves simply self-seekers, since that is what they assumed of us? It is true that many of those most intimately involved with imposing the new regime then and later did very well out of it. But even if we maintain the polite convention that all was meant for the greater good, we could be left with the genuine and sad paradox: the architects of New Zealand's more-market revolution actually did not understand how a successful market economy functions.

Perhaps the most compelling corroborating evidence for this position comes from a recent study by three NZ Treasury economists, Melleny Black, Melody Guy and Nathan McLellan (2003), whose careful decomposition of the difference in recent Australia and New Zealand GDP output growth end up attributing just about all of it -- in a growth accounting sense -- 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 policymakers, 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 greenfields investment which 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.

4. Outlook for the future

After adopting very different approaches to micro-economic reform during the 1980s, Australia and New Zealand now appear to be converging in terms of economic policy. It seems reasonable to suggest that, in the next few years, the most notable remaining differences will have disappeared, and policy will once again move in parallel in the two countries

On the one hand, although the pace of reform in Australia has been slower than in New Zealand, the reform policy agenda of the 1980s remains influential. With the removal of the obstacle posed by Opposition control of the Senate, the Howard government will be in a position to complete the two most significant items of 'unfinished business'[7], namely the full privatisation of Telstra and industrial relations reform. Although there have been some calls for a new round of radical microeconomic reform, the only concrete policy proposals to emerge have been calls for tax cuts, financed out of budget surpluses rather than by reducing public spending. It seems likely therefore that the pace of reform will slow even further when these reforms are implemented.

On the other hand, the Clark government, having repealed or modified some of the more extreme elements of the reform program, has shifted New Zealand back towards the policy mainstream, and this process also seems likely to continue.

Both in Australia and New Zealand, governments seem to have settled into a largely managerial mode, making modest adjustments to a policy framework that is seen, by governments at least, as representing a broadly satisfactory response to contemporary economic and social conditions. By comparison with the socialist and social-democratic reformism that dominated the first three-quarters of the 20th century, and the radical free-market counter-reforms of the 1980s and 1990s, the last few years have seen only

[7] This phrase was the title of Roger Douglas's 1993 call for a further round of reform after the fall of the NZ Labour government . It neatly capture the idea of a predetermined policy agenda, to be implemented without much regard to specific circumstances.

modest policy changes, with no obvious reform agenda in sight.

The likely outlook for the immediate future is one in which the role of government changes only modestly, in both quantitative and qualitative terms. In quantitative terms, the most obvious measures are the ratios of public expenditure and taxation revenue to GDP. The ratio of tax revenue to GDP in Australia is about 30 per cent, and in New Zealand about 34 per cent. This ratio has risen slightly in Australia over the past decade, and has fallen somewhat in New Zealand.

In qualitative terms, the range of activities undertaken by government seems to have stabilised, ending the wave of privatisation and retrenchment that characterised the era of market-oriented reform. Although the privatisation of Telstra seems inevitable, the government appears to have little interest in what would seem to be the obvious corollary of privatising Australia Post. Conversely, despite the emergency renationalisation of Air New Zealand, and the establishment of a new publicly-owned savings bank, it seems unlikely that the Clark government will attempt to reverse the large-scale privatisation undertaken during the 1980s and 1990s.[8]

More importantly, in both Australia and New Zealand the government has retained its central role in the funding and provision of health and education services. Attempts at radical reform in New Zealand under the National government were a failure, as were more subtle attempts to erode the role of Medicare in Australia. The Australian government has, however, expanded public subsidies to private providers of health insurance and to private schools. These subsidies have increased the share of the student population in private schools and have, at least arguably, slowed the erosion in the proportion of the population with private health insurance.

The shift in the Australian government's position was made evident during the 2004 election campaign by John Howard, in an interview with the *Australian Financial Review* (Sept 22) when he observed 'There is a desire on the part of the community for an investment in infrastructure and human resources and I think there has been a shift in attitude in the community on this, even among the most ardent economic rationalists.'

Until recently, the best description of the government position on public spending was 'creeping residualism'. The preferred option was to replace systems of universal provision such as Medicare and public schools with a "safety net" for the poor while everyone else got subsidies for private provision.

The new position, most evident with Medicare, might be called "Universalism Plus Choice". In relation to health, this means ensuring universal access to bulk billing and public hospitals while also encouraging private health insurance. Similarly, while maintaining increased funding for the richest private schools, Howard has restored funding for public schools and the poorer private schools.

The new position has obvious problems. In some respects Howard has behaved like the rationalist caricature of a social democrat, eagerly seeking out interest groups at which to throw government money. Many of the new spending proposals are poorly targeted, except in purely electoral terms.

The New Zealand government has adopted various descriptions of its policy framework, flirting with the 'Third Way' before shifting towards modern/mainstream social democracy. Although there is, perhaps, more emphasis on universalism and less on choice, the Clark government's position is not radically different from that of the Howard government.

The relative economic and political stability apparent in both Australia and New Zealand reflects the fact that the ruling parties in

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[8] A recent NZ public opinion poll revealed a remarkable degree of opposition to privatisation, across supporters of both the major political parties.

both countries ave enjoyed, and claimed credit for, sustained economic expansion. This expansion rests largely on domestic demand, driven by strong growth in the price of houses and other assets, and has been associated with expansion in current account deficits that were already large relative to those of other countries and relative to historical experience.

The obvious question is whether the current policy mix will be seen as appropriate if this expansion proves to be unsustainable and, if not, what will replace it?

5. Conclusions and implications for globalization

In their chapter on economic reform in *The Great Experiment*, Brian Easton and Rolf Gerritsen (1996) 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 NZ'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.' (p43).

They document two line of argument. The first, which we rejected above (though not for quite the same reasons as do Easton and Gerritsen), is that NZ's initial conditions were so much more unfavourable than Australia's as a result of the poorer policies followed pre-reform. 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 prevarications and procrastinations. 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 complements our list in section 3 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 globalization. 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, alas.

But New Zealand did deviate from the global policy norm: it went much further! Perhaps this is why it did so poorly. Such is not an interpretation that would be favoured by economic rationalists, if any remain. More seriously, we can point to recent evidence on the 'border effect' (Hazledine and Lipanovic, 2004) which reveals just how persistent --as an economic force -- is the nation state, even in a 'world without walls', and the detailed examination of economic policy and policy differences between Australia and New Zealand surely supports the proposition that nation states are still free to make choices, including bad choices.

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Figure 1: Ratio OZ/NZ Real GDP per capita