

Liberální Institut

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"Evaluation Criteria of Successful Economic Reform"

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The transition of New Zealand from an economy in the 1980s which the Australian Government security advisers told Prime Minister Malcolm Fraser in the late 1970s was headed into decline and therefore a security risk to Australia to one today where New Zealand is enjoying its most sustained economic recovery and makes New Zealand one of the highest performing economies in the OECD, is an interesting story.

Prime Minister David Lange in the mid 1980s described the economic policy regime New Zealand had been following as comparable to the management of a Polish shipyard at the time.

Past economic problems in a nutshell -

In the decade to 1984:

- New Zealand's economic growth rate had averaged half the OECD average.
- Our inflation rate was 1½ times the OECD average rate.
- Government expenditure rose from 28% of GDP to 39% with additional costs hidden in various Government business agencies.
- Net public debt multiplied six times over and debt servicing mushroomed from 6½% to 19½% of total Government spending.
- Unemployment rose from 5,000 to 132,000 with no sign of stopping there.

In the 25 years to 1984:

- New Zealand's average annual increase in productivity was the lowest in the OECD.
- New Zealand's relative standard of living fell from third highest in the world to a mid-twenties ranking. To put it another way, had New Zealand succeeded in growing at the OECD **average** rate, the standard of living of New Zealanders by 1990 would have been double what it, in fact, was.

Main elements of regime of economic controls as at 1984

- Regulations freezing all wages, prices, dividends, rents, interest
- All prices and charges for Government supplied services frozen
- Exchange controls restricting all foreign exchange transactions to items approved by the Reserve Bank - the criteria largely prohibited capital transactions, restricted remittances for current transactions and ensured export earnings were repatriated
- Quantitative licensing of imports to preserve the domestic market for local manufacturers
- Extensive subsidies for all major export sectors
- Tariffs that were very high on items for which there were domestic substitutes and low or zero for intermediate inputs to industry
- Requirements on financial institutions to hold Government bonds at below-market interest rates

- Prohibitions in public sector pension funds investing other than in Government stock
- Extensive regulatory protection and/or Government ownership of the non-tradeable sectors - transport, energy, communications, finance, construction and others.

How New Zealand drifted into structural imbalance

After the 1930s depression, New Zealand aimed to insulate itself from international economic shocks and boost urban employment by raising substantial barriers to international competition.

Manufacturing subsequently developed a high cost structure which precluded it, in large degree, from export activity. The costs thus imposed on the economy, over time, reduced the competitiveness of our agricultural exporters.

Those problems were intensified by British entry into the EC and the oil shocks of the 1970s. Balance of payments problems became endemic. Instead of facing the real problems, the Government began to subsidise farmers to compensate for those costs, and subsidised uncompetitive manufacturers into the export business.

Public money was used to underwrite multi-billion-dollar energy projects which the private sector had correctly rejected as bad commercial risks. Returns proved to be zero or negative.

In 1982, as the imbalances worsened, prices, wages, interest rates and rents were all subjected to direct controls by a conservative Government, in a vain attempt to tell the tide to turn back.

The distortions in New Zealand's resource allocation, which had caused our problems in the first place, were thus compounded. By 1984, the situation was no longer sustainable, and a run on the New Zealand dollar brought it to crisis point.

To put it in economic terms -

- Government policies distorted price signals from the world economy about the best use of resources - particularly tariffs and imports controls
- Macroeconomic policies focused on stability at the expense of growth through efficient resource use
- Regulatory policies (labour, trade and commercial laws) biased against efficiency and innovation and used for protection and stabilisation.
- Inflation and tax policies channelled resources into risky and low productivity activities.
- Financial controls brought about an inefficient capital market.
- Social policies resulted in high marginal tax rates and unaffordable universal benefits - still a major problem for New Zealand.
- Government businesses were badly managed, protected, subsidised and influenced a large share of the country's resources
- Government administrative activities were unresponsive to changing priorities and performing inadequately in terms of effectiveness and efficiency
- Low skill levels in the workforce and poor management

New Zealand's approach to structural change

New Zealand is a trading nation. We earn our living standard by selling for commercial profit against competition on the world market.

To achieve that, our producers had to be just as efficient and innovative as their competitors. New Zealand needed economy wide reforms designed to:

- Take short term adjustment costs on the chin for the sake of medium term benefits for all New Zealanders
- Institute a firm anti-inflationary monetary policy
- Deregulate the finance sector
- Open over protected industries to international competition
- Improve the quality of Government spending, thereby reducing the cost burden placed on private sector initiative
- Increase the transparency of Government decisions so that the real costs were available to the community
- Remove subsidies, incentives and concessions so that exporters were forced to live or die in the market place
- Make our labour market more responsive to market opportunity
- Lower marginal tax rates across the board to provide all our citizens with more effective incentives
- Improve resource allocation by creating a level playing field for everyone, so that resources would flow into the areas offering the best returns to investors and the nation

Policies implemented in New Zealand to achieve these ends :

- Devaluation followed by floating the exchange rate
- Remove regulations on financial markets
- Remove subsidies to industry
- Tax reform to lower rates and broaden tax base
- Cut fiscal deficit by both revenue and expenditure measures
- Raise Government revenue through user-pays
- Remove regulations on prices and incomes
- Remove quantitative restrictions on imports
- Cut tariffs and even up the levels
- Reform commercial regulations and laws to promote efficiency and innovation
- Corporatise and privatise Government businesses
- Guaranteed minimum incomes for the poor
- Training schemes for unemployed
- Target welfare State support on those in need
- Reform social service delivery by Government agencies in a search for greater equity and efficiency
- Labour market reform
- Reform commercial regulations and laws to promote efficiency and innovation
- Reform Government management to achieve greater effectiveness and efficiency
- Firm monetary policy focused on a medium term inflation target by creating an independent central bank

RESULTS

Fiscal policy

- Government expenditure ratio to GDP peaked in 1991-92 at 44% and is now 33% and Government plans to reduce it to 20-30%
- The Government ran its first surplus for 17 years in 1995

- Net public debt 30% GDP after peaking at 51% in 1992 (40% at the beginning of the reform period)
- Ratio of debt service to Government revenue 11% down from 20%
- Surpluses to be used to lower public debt from 42% GDP to half that
- The net worth in the Government balance sheet is now positive
- Interest rates peaked in 1987 (90 day 25%, 5 year 18%) and reached a trough in 1992-3 (90 day 7%, 5 year 6%)

The country risk premium in interest rates has fallen.

The OECD says the tax system is the least distortionary in the OECD

Infrastructure

- Costs are down for key infrastructure as a result of reform:
 - Port handling charges down 60%
 - Rail freight down 50%
- Government businesses contribute 5% of GDP down from 12% and the remainder are very much more efficient and profitable
- Government administration is smaller (staff numbers down from 88,000 to 34,000) and more effective.

Let me turn to some of the lessons that can be learnt from New Zealand's experience.

Lesson

Any major programme of economic reform has to be comprehensive. There is little point playing around with some areas while leaving other areas largely untouched.

Clearly, for example, the results of the goods market depend on the performance of the capital and labour markets. They also depend on the efficiency of Government management.

It simply makes no sense at all to construct an efficient economic system if the largest player, the Government is inefficient.

In New Zealand, Government took close to 40% of GDP in the 1980s - if the Government services exporters need are provided inefficiently, then that is a tax on exporters.

Lesson

It is the interaction of policies one to another that matters rather than any one policy.

There is no one magical policy change that is capable of turning an economy around, rather it takes a large number of comprehensive and often complex changes to do it. In other words, it is the interaction of policy one to another that matters. No one policy on its own.

This needs to be not only understood but also practised if a country is to be successful with its reform programme.

E.g. Many people will say that New Zealand's much better labour market today is entirely due to the employment contracts act of 1991.

Not so - the employment contracts act of 1991 was a major achievement and changed industrial relations for ever in New Zealand - but the fact is that there have been a large number of economic and social policy changes that affected the working of the labour market in New Zealand.

- Changes in border protection have affected employment and manufacturing.
- Changes in monetary policy altered traditional pay fixing.
- Changes in Government management practices changed dramatically employment conditions in that sector.
- Changes to taxes and benefits dramatically altered the incentives to take on various jobs.
- A flatter tax scale dropping the top rate from 66c in the dollar to 33c in the dollar impacted on people's willingness to work longer hours.
- Reduced welfare benefits increased the gap between those in work and those on welfare, encouraging people to take jobs that they would not have looked at before.
- Tighter eligibility rules for social welfare also had an impact.
- Education and training programmes were also designed to help.

Lesson

Policies must encourage efficiency i.e. The production and use of goods and services should be maximised, with the least use of resources.

Lesson

Policies need to be practical. It is not enough to follow a particular ideology, the policies must relate to a real world context taking account of the goal, aspirations and incentives facing individuals.

Lesson

The changes need to be dynamic in the sense that they are ongoing. This does not imply a continuous revolution, but it does mean that there is a steady focus on changing circumstances and a willingness to adapt policy to meet new opportunities and threats as they arise.

Lesson

Policies need to create an appropriate incentive structure. The question needs to be asked - what incentives does this policy create?

E.g. Income Support policies have as their objective, the redistribution of income fairly and efficiently, yet they often take from the responsible poor and give it to the least industrious, least responsible poor.

Lesson

Quality decisions are the key to structural reform and to political success in Government.

A fundamental choice is always there: you can take the costs up front for larger medium term gains, or focus on short run satisfaction and be sandbagged later by the accumulated costs.

The problem with compromise policies is simple. They do not produce the right outcome for the public at the end of the day so they come back to haunt the politicians responsible for them.

Going for quality means choosing the actions that deliver most benefits to the nation in the medium term instead of choosing more now for supposed political gain, at the cost of less later.

NEW ZEALAND'S RESPONSE TO QUALITY POLICIES

Wherever the New Zealand Government implemented uncompromised quality policies since 1984, the opinion polls show that voters today give a satisfactory rating to the Government's performance.

Wherever they did not go the whole way for quality decisions during that period, they trail behind the opposition.

To illustrate the point, let me give three different kinds of examples drawn from local experience in the past ten years, and look at what can be learned from those events.

Quality in taxation reform

Many countries have introduced their VAT type taxes with a wide range of exemptions dictated by political fear. They saw that as the easiest way to take the sting out of public criticism.

In New Zealand, we took that criticism on the chin up front, in order to introduce a flat 10% GST without exemptions, to avoid distortions and keep compliance costs to an absolute minimum.

Some people argued bitterly that it was regressive to impose a flat rate. They wanted either no GST at all, or exemptions for goods that are essentials of life to people on low incomes. It took courage up front.

95% of New Zealanders opposed GST on doctors' fees, to take one example. Before implementation, public support averaged only 30% in the polls.

We argued that high income people benefit most from exemptions. In New Zealand they spend twice as much as low income people, on food, and nearly 8 times more than the poor on clothing.

Clearly, it did not matter if GST was regressive, provided that the tax/benefit system, taken as a whole, was not regressive. By thinking laterally, we produced a package with that outcome.

Income tax rates were reduced substantially the day GST was introduced, and family support programmes were redesigned to ensure that low and middle income families emerged net winners.

Within a fortnight of its introduction, GST's poll rating had risen by one third. The tax was accepted as a fact of life, and it has never been a political issue at any stage since then.

The opposition had tried to make capital out of GST by promising to repeal it and replace it with "ex tax" - a retail sales tax with exemptions. They fell flat on their face, and had to back away from the promise.

Quality decisions, instead of treating problems separately, recognise and exploit economic and social linkages, so that every action improves the working of the system as a whole.

Quality in finance sector deregulation

The July 1984 devaluation, necessitated by the run on the New Zealand dollar, was followed by the abolition of interest rate controls as a precondition for an effective disinflationary monetary policy.

Foreign exchange controls were abolished. So were reserve ratio requirements on financial institutions and lending growth guidelines. New Zealand moved to a clean float of the dollar.

The previous monopoly held by 4 trading banks was opened up - 12 new banks had registered by the end of last year - and a modern system of prudential supervision was set in place.

A Reserve Bank amendment bill requires the Government to give public notice to the Reserve Bank if it wishes to change the priority placed by the Bank on price stability.

Systematic financial deregulation greatly increased the sector's efficiency, encouraged rationalisation and innovation, cleaned up the price signals, and placed a key role on reducing inflation.

Those changes, which many would have regarded as highly controversial and politically impossible 15 years ago, were very rapidly accepted as an integral part of our way of life.

Quality in public sector reform

Successive New Zealand Governments have carried out substantial reform and restructuring of the State Sector since the mid 1980s.

Key principles of reform

- The State should not be involved in any activities that would be more efficiently and effectively performed by the private sector or community
- Trade enterprises should be structured along private sector lines, i.e. corporatisation
- State departments need clearly specified and unambiguous functions
- Departmental managers should be made fully accountable, without central control
- State activities should operate on market prices

Key legislation

- State Owned Enterprises Act 1987 : provided the basis for converting the old trading departments and State corporations into businesses along private sector lines e.g. the electricity and mines divisions of the old Ministry of Energy became Electricorp and Coalcorp; the postal division and telecommunications divisions of the old NZ Post Office became NZ Post and Telecom.

- State Sector Act 1988 : made department CEOs fully accountable for managing their organisations efficiently and effectively. The State Services Commission changed from being employer and manager of the public service to employer of the CEOs.
- Public Finance Act 1989 : changed the basis of state sector financial management from a focus on inputs (the costs of production) to focus on outputs (relevance and value of what each department produced) and on outcomes (the overall results of these outputs from the Government's point of view).

Privatisation

- Government policy has been to sell state assets that it lacks reason to retain.
- Also came in form of doing away with departmental monopoly rights.

Social policy

The Government has developed a number of goals for social policy

- An integrated approach to achieve consistency in housing, welfare, health, accident compensation and education
- Social assistance is focused on those in genuine need
- Providers of social services should be more responsive to the needs of individuals and their families
- The Government should provide services that the country can afford

The New Public Sector

The new public service is characterised by small departments, with sharply defined policy advice, regulatory and sectoral funding functions. The number of public service employees has fallen from 88,000 in 1984 to 34,000 in 1994.

Many old departments have disappeared, been restructured or corporatised e.g.

- The Ministry of Transport kept its policy role but shed its provision of services and regulatory functions which were established in new agencies: Airways Corporation, Civil Aviation Authority, Land Transport Safety Authority, Maritime Safety Authority, Transport Accident Investigation Commission, Transit NZ (funding and management of roads) and Railways Corporation (since privatised).

Core State Departments which remain include:

- The Treasury (Finance Ministry), Inland Revenue Department (taxation), Customs
- Ministry of Foreign Affairs and Trade, Ministry of Commerce
- Ministry of Education and Ministry of Health (both now exist as policy advisors and regulators rather than providers of educational or health services, which have now been contracted out to school boards and area health boards)
- Departments which provide advice and provide services e.g. Social Welfare, Conservation, Internal affairs, New Zealand Police
- Policy ministries such as Ministries of Defence, Environment, Women's Affairs, Consumer Affairs, Youth Affairs, Fishing, Forestry, Justice, Labour, Maori Development, Pacific Island Affairs, Prime Minister and Cabinet.

Independent audit and oversight agencies have evolved e.g..

- Ombudsman, Human Rights Commission, Privacy Commissioner, Police Complaints Authority, Serious Fraud Office, Parliamentary Commission for the environment
- The Official Information Act 1982 is based on the principle that information shall be made available unless there is good reason to withhold it

Results of Reform

- Public sector percentage of GDP has fallen
- Government has moved from persistent budget deficits to budget surplus
- Public sector debt has decreased: public foreign sector debt will be eliminated within a year.
- Many Government organisations previously subsidised by the taxpayer are now profitable: some have been sold, e.g. Telecom NZ (telecommunications), Tranzrail (railways), Bank of New Zealand (largest commercial bank), Coalcorp (coal mines)

Lessons of New Zealand Experience

These experiences in New Zealand provide an important insight into the nature of political consensus, which is widely misunderstood by politicians in New Zealand and around the world.

The conventional view is that consensus support must exist for detailed reform before you start, otherwise the actions taken will not prove to be politically sustainable at election time.

The tendency is to seek consensus in advance by compromising the quality of the decisions to bring the benefits up front, and either ignore any costs, or push them further down the track.

But when the Government compromises its decisions for immediate advantage at the expense of the medium term outcome, the dissatisfaction of the public will intensify over time.

The fact of the matter is that the interests of the various groups are complex and diverse. None of them welcome the idea that their traditional privileges may be removed.

Consensus for quality decisions does not arise before they are made and implemented. It develops progressively after they are taken, as they deliver satisfactory outcomes to the public.

To win elections, Governments need the guts to implement quality decisions, take the pain up front instead of postponing it, and be judged on the basis of the good outcomes they deliver.

Lesson

Policy starts with people. It emerges from the quality of the observation, knowledge, analysis, imagination, and ability to think laterally to develop a wider range of options.

The success of Public Sector reform in New Zealand since 1984 depended on people as much as policy. Replacing people who cannot or will not adapt to the new environment is pivotally important.

But getting the incentives and the structure right can also transform the performance of many dynamic and capable people who were not able to achieve the right result under the old system.

The head of one of our old trading departments for example was told he would not be needed in the new corporation because under him, the outfit had been spending millions more than its income.

So what he retorted - those were the rules then - these are the rules now, I have no problem with that! The stunned chairman saw the point, gave him the job and he did it very well indeed.

Lesson

Do not try to advance a step at a time. Define your objectives clearly and move towards them by quantum leaps. Otherwise the interest groups will have time to mobilise and drag you down.

The political problems involved in making a conventional attack on protection are well understood. The benefits of protection are substantial in the hands of the favoured few who receive them.

Such groups are usually well organised. They tend to scream blue murder if anyone threatens to remove their privileges. They are capable of mobilising quite powerful opposition against reform.

The cost of protection, however large in aggregate, is relatively small per person per item, widely dispersed across the rest of the economy, and often invisible to the people paying the bill.

At best, they are weak and disorganised allies of reform. At worst, the campaigns of the interest groups may exploit their ignorance to persuade them that reform will damage the nation.

Here and worldwide, the conventional perception is that reformers are playing against a stacked deck of cards. Genuine structural reform is portrayed as equivalent to wilful political suicide.

That rule holds good where privileges are removed one at a time in a step-by-step programme. Paradoxically, it ceases to apply when the privileges of many groups are removed in one package.

In that case, individual groups lose their own privileges, but simultaneously, the aggregate cost of paying for the privileges of all of the other groups in the economy is removed from them.

Paradoxically, it is harder to complain about damage to your own group, when everyone else is suffering at least as much - and you benefit from their loss, in the medium term.

Packaging reforms up into large bundles is not just a gimmick. Its political and economic efficiency rests on fundamental considerations which are the essence of good structural reform :

The economy operates as an organic whole, not an unrelated collection of bits and pieces. Structural reform aims to improve the quality of the interactions within the whole.

When reform is packaged in large bundles, the linkages in the system can be used that each action effectively enhances every other action - and also improves its selling potential.

Winning public acceptance depends crucially on demonstrating that you are improving the opportunities for people as a whole, while protecting the most vulnerable groups in the community.

Large packages provide the flexibility needed to demonstrate that the losses suffered by a group of people are offset by fundamental gains for the same group in some other area.

The public will take short term pain on the chin, if the gains are spelt out convincingly, and the costs and benefits have been shared with visible fairness across the community as a whole.

Obviously fairness does not include compensation for those who are losing their past privilege, but even they make genuine fundamental gains after they have come through the adjustment.

If insufficient consideration is given to these balances, the reactions of aggrieved people forced to take more than their share of the costs will end up tearing the reform process apart.

Lesson

Speed is essential, once a programme is worked out, it is impossible to go too fast. Even at maximum speed, the total programme will take years to implement. The short term trade off costs start from day one.

When reform has been delayed for many years, the trade off costs are inevitably considerable. Tangible benefits take time to become visible, because of the lags built into the system.

If action is not taken fast enough, the general consensus that supports reform can collapse before the results become evident, while the government is still only part way through its reform programme.

There are serious inherent dangers in seeking to hold down the pace of change in order to satisfy groups that claim a slower pace would give the community more time to adjust with less pain.

If an attempt is made to do so, it takes only a modest error or a miscalculation of external circumstances to end up going backwards instead of forwards, and destroying your credibility.

Vested interests seeking to preserve past privileges will always argue strongly for a slower pace of change. It gives them more time to mobilise public opinion against the reforms.

On the other hand, vested interests cannot obtain the pay off from change until the government has moved far enough to reduce the costs imposed on them by the privileges of other interests.

The vested interests continuously underestimate their own ability to adjust successfully in an environment where the Government is rapidly removing privilege across a wide front.

In 1984, the Chairman of the New Zealand Dairy Board told me that farmers could not survive an exchange rate above 44c to the us dollar without going broke. At that time, the rate stood at 50c.

When the New Zealand dollar had risen to 55c, farmers argued that anything higher than 50c would put farming out of business, and said that 55c was driving the whole industry into bankruptcy.

When the exchange rate reached 70c to the us dollar, they started telling me that, at 62c or 63c they would probably be all right.

They were focused on symptoms, not fundamentals, at every stage.

It is uncertainty, not speed, that endangers the success of structural reform programmes. Speed is an essential ingredient in keeping uncertainty down to the lowest achievable level.

A great deal of technical debate has been aired worldwide about the optimum sequencing of structural reform, and the alleged sequencing errors of Governments, both here and elsewhere.

Those armchair theorists postulate the desirability of tackling the labour market or the tradeable goods market before embarking, for example, on the deregulation of sectors such as finance.

At a purely analytic level, that debate is entertaining, but no clear-cut answers emerge. Moreover, from my point of view as a practitioner, the question is fundamentally irrelevant.

Before you can plan your perfect move in the perfect way, at the perfect time, the situation has already changed anyway. Instead of a perfect result, you wind up with a missed opportunity.

Some decisions take full effect the day they are made. Others take 2-5 years of hard work before they can be fully implemented. Perfect sequencing, even if it existed, would not be achievable.

If a window of opportunity opens up for a decision or action that makes sense in the medium term, use it before the window closes.

When an economy has been driven down a blind alley and ends up facing a brick wall, what matters is to back it out as soon as possible, and get it back on the high road to a better future.

Lesson

Once you start the momentum rolling, never let it stop until you have completed the total programme. The fire of the opponents is much less accurate if they have to shoot at a rapidly moving target.

If you take your next decision while they are still struggling to mobilise against the last one, you will continually capture the high ground of national interest and force them to fight uphill.

The Government can develop public awareness of the key issues by structuring the content and sequence of its packages to dramatise the relevance of the fundamental economic linkages.

By the end of 1985, for example, the adjustment costs were biting quite deeply into pastoral farming, which had lost some large subsidies and was also facing low international commodity prices.

Land values were tumbling back from the inflated levels stimulated by the previous Government's assistance measures, and equity problems of considerable magnitude had begun to emerge.

Nevertheless, resource allocation in farming and forestry was still being distorted by large concessions that let people write off livestock and development costs against other taxable income.

People buying livestock were happy to bid prices up to two or three times the value justified by market returns, because they knew that the taxpayer was covering two-thirds of their costs.

Tax write-offs had led the wine industry to plant twice the acreage needed to satisfy the market, and boosted wine stocks to three years' supply, against an international norm of half that.

The Government decided that, despite the adverse climate and the increased cost for those concerned, all such concessions had to be removed to promote the medium term health of their industries.

To combat the inevitable outraged reaction, we moved the whole reform programme into a higher gear. In the same package, we announced an unprecedented onslaught on public sector waste.

The underlying process is very important. **Before** you remove the privileges of a protected sector, it will tend to see structural change as a threat which has to be opposed at all costs.

After you remove its privileges and demonstrate that the clock cannot be turned back, the group starts to focus on removing the privileges of other groups that still boost its own costs.

On the other hand, exactly the opposite process occurs wherever some favoured group is allowed to retain its privileges, and given on going protection from the broad thrust of the reforms.

Anxiety levels in protected groups rise steadily as reform progresses in the rest of the economy. They fear their turn may come next. Their internal organisation improves dramatically.

They boost their public profile. They entrench their opposition. To conceal their vested interest in exemption from reform, they will aim to dictate the rhetoric that governs all public debate.

The strategy of this rhetoric is to obliterate public awareness of all medium term benefits, exaggerate the short term costs, and portray those costs as the objective and sole outcome of reform.

Those groups end up making strenuous efforts to gain control of the political process in the reforming party, to stymie any threat to themselves by terminating the total reform programme.

The answer is : stop the rot before it begins. Remove privilege even-handedly across the board and give such groups, along with everyone else, a more constructive role in a better society.

Lesson

Continuous credibility is essential to maintain public confidence in structural reform and minimise the costs. The key to credibility is consistency of policy and communications.

Take the first step early, and make it a big one. You have to break the pattern of the past dramatically enough to convince the community that, this time, somebody really does mean business.

When the Government lacks credibility, people refuse to change until the clash between their old behaviour and the new policy imperatives has imposed large, avoidable costs on the economy.

As the reform programme rolls forward, a lot of people start hurting. Their confidence depends on maintaining the conviction that the Government will drive reform to a successful conclusion.

Speed, momentum, the avoidance of ad hoc decisions, and an unwavering consistency in serving medium term objectives are the crucial ingredients in establishing the Government's credibility.

Resolution is particularly important when, notwithstanding the best of intentions on the Government's part, the community remains sceptical and refuses to learn before it gets hurt.

You know when you start to win the credibility battle : the media begin to put every Government statement under a microscope, looking for inconsistent decisions and lapses of principle.

People begin to grasp the idea that wherever a group manages to hold on to privilege and protection, an avoidable cost is imposed on those who are facing up to the adjustment process. The message from the voting public changes.

It now reads: "keep the reform process going - drive it to a successful conclusion, or you are dead in the water at the next election."

Structural reform has its own internal logic, based on the linkages within the economy. One step inevitably requires and leads to another, to extract benefit for the nation as a whole.

Abolishing export assistance is fruitless unless the costs of exporters are also reduced by lowering tariffs, deregulating internal transport and reforming ports and shipping services.

The fiscal gains from corporatisation or privatisation will vanish without trace if expenditure in an unreformed social services sector is left to rise without regard for efficiency.

The redundancies created as production is rationalised to improve efficiency may turn into more or less permanent unemployment if an inflexible labour market protects insiders against outsiders.

Where the logic of reform is not followed closely enough, the confidence of investors will be impaired, and the ultimate sustainable growth rate achieved may be less than optimal.

The battle for consistency and credibility is always ongoing, and never finally won. It remains permanently central to every decision that comes before the Government for consideration.

Winning back lost credibility can take longer than winning it did in the first place. If confidence starts to waver, push the reform programme forward a big new step - and take it quickly.

Lesson

Let the dog see the rabbit. People cannot co-operate with the reform process unless they know where you are heading.

Go as fast as you can but, where practicable, give them notice by spelling out your objectives and intentions in advance.

Where programmes can or will be implemented in stages over time, publish the timetable up front.

Those strategies are particularly important in areas such as the removal of import licensing and reductions in tariffs, which impose major changes in the way firms go about their business.

Obviously, major reductions in protection could impose an unmanageable burden on high cost industries if other simultaneous reforms were not occurring elsewhere in the system.

Decision makers must be able to see as much as possible of the total pattern of change affecting their businesses in the period ahead of them, in order to plan an effective adjustment.

The release of information also places professional analysts throughout the community in a position to make their own independent evaluation of progress and Government performance.

They understand the importance of quality in decision making, and the benefits available via consistent medium term policies. They are often trusted advisors of the interest groups.

Over time, their objectivity, combined with their increasing good will towards the reform programme, becomes one of the major factors in creating a favourable climate of public opinion.

The confidence of the community is further increased if private sector people respected for their experience and capability are involved in helping to fine-tune policies and improve management.

Expert panels appointed from the private sector, for example, received the public submissions on our major tax initiatives, to help remove any administrative bugs from the new systems.

Lesson

Never fall into the trap of selling the public short

Do not mistake the fears of the politicians for ignorance, lack of guts or lack of realism on the part of the voting public.

The people out there in the community trade off short term costs for long term benefits every day of their life. They take out mortgages and bring up children.

Nobody stops to think that what people may really want is politicians with the vision and the guts to help them to create a better country for their children in the year 2000 and beyond it.

Successful structural reform does not become possible until you trust, respect and inform the electors. You have to put them in a position to make sound judgements about what is going on.

Tell the public, and never stop telling them, right up front:

- What the problem is and how it arose;
- What damage it is doing to their own personal interests;
- What your own objectives are in tackling it;
- How you intend to achieve those objectives;
- What the costs and the benefits of that action will be;
- Why your approach will work better than the other options.

Ordinary people may not understand the situation in all its technical detail, but they have a lifetime of experience at work and at home to help them sift the wheat from the chaff.

They know when key questions are being evaded. They can sense when they are being patronised or conned, and do not like it. They respect people who front up honestly to their questions.

Lesson

Don't blink: public confidence rests on your composure

Structural reform in new Zealand involved ministers in making some of the most radical decisions announced to the public for 50 years or so.

Relaxed, matter of fact composure is essential every time you face the public. Their confidence is always based on yours.

As the pressure of change comes on to the economy, the whole community starts watching every television appearance like a hawk, looking for the least twitch of Government nervousness.

Their confidence in, and co-operation with, the reform programme can be undermined by the least blink. Visible uncertainty among key Ministers spreads like a plague throughout the community.

Structural reform demands a major change in the ideas and attitudes which ordinary people grew up with. Such demands inevitably cause discomfort and uncertainty in many people.

Our qualitative research showed that, in the process, people become hypersensitive to any signs of similar anxiety in the politicians who are responsible for the reform programme.

They attend meetings and watch the TV news not just to find out what is happening and understand the ideas behind it, but also to probe the feelings and emotions of the people at the helm.

When they cannot understand the technical detail of the argument, they rely on their own assessment of the speaker's mental and emotional condition to provide them with a basis for judgement.

That is another reason why it pays to make decisions of the finest quality. When you know you got it right and know the policies are on course, that comes out through their TV sets.

Knowing or believing that you have got it right provides a firm foundation for dealing with people in a relaxed, confident way when you are face to face with them, even at large meetings of quite angry people.

These remarks are not a recipe for arrogance. Listening to arguments from sources of every kind is fundamentally important to policy making, as well as to selling policies successfully.

But all of that advice has to be measured against the Government's medium term goals. It is not arrogance to hold a sound course towards objectives that benefit the country.

Lesson

Incentives, choice, monopoly: get the fundamentals right

A sick economy cannot be regulated back into health. Economic dynamism is the liberated energy of people at every level personally choosing and using opportunities that benefit them.

Government's role is to create a framework that widens their opportunities for choice, improves the incentives to productive activity and sees that their gain benefits society as a whole.

In other words, **remember whose side you are on.** Interest groups, whether of farmers, manufacturers, teachers or health workers - exist to serve the interests and improve the lives of consumers.

The purpose of economic activity is to satisfy the needs of consumers. Government is not there to protect vested interests at the expense of the consuming public. Its role is to ensure that vested interests cannot thrive except by serving the general public effectively.

In command economies, the theory was that such problems would disappear if Governments took the power to make all the important decisions on behalf of the general public, to protect people.

Since 1917, that theory has been tested to extinction. The power they used was taken away from the people themselves. Government became the most oppressive vested interest of all.

Here in New Zealand, the Government, by its past domination of areas like coal mining, electricity, education, health and welfare has often gone quite a long way in that direction.

Monopoly versus choice in the social sector

Opinion polls leave no doubt, in all the areas in New Zealand where reform has been implemented that the voting public endorses the extensive action taken to reform and restructure those huge areas of the economy.

On the other hand, wherever our policies have gone only part of the way towards reforms of uncompromising medium-term quality, the Government is equally clearly in trouble now with the public.

Public discontent with the Government's performance is most intense in social policy areas such as health, education, welfare and race.

Successive Governments have, in fact, been very determined to achieve major improvements in quantity and quality of health and education services. They were given special status and top priority.

By deliberate decision however, the social services sector was exempted from the pressures of restructuring which the Government imposed on most of the rest of the economy.

While many other departments were facing expenditure cuts, health and education budgets were boosted 20% in real terms in that period - a very large increase indeed.

In the event, demand for funds in both areas has increased at an even faster rate, with little evidence that the extra money improved either the quality or quantity of service.

Evidence is not available to be definitive about the levels of waste and inefficiency in the social services sector as a result of perverse incentives and inadequate accountability.

Nothing, however, suggests that it is likely to be any lower than the levels we found in state trading enterprises.

In New Zealand, the Government has traditionally been, and continues to remain, by far the dominant supplier of health and education services. Contestability is relatively minimal.

The Government view has been that access to health and education could be guaranteed only if the state continued to provide the service.

The view has been that providing low-income consumers with the money to buy such services from competing suppliers was not an option because a future Government could alter that the stroke of a pen.

The evidence of New Zealand experience, in fact, is that the best protection is a system that delivers a satisfactory outcome and gains, for that reason, the support of a sustainable consensus.

Given the basic policy stance adopted, the key problem facing the Government in these areas has been :

- "how do you subject providers to the discipline of consumer choice in a system dominated by one monopoly state supplier?"
- "how do you attack waste effectively when contestability and competition are outlawed by the rules of a monopoly state supplier?"

At the end of the day, there is only one test that really matters when it comes to determining the level of Government activity that is appropriate i.e. the Government should only tax its citizens when it can spend the money to better advantage than it would have been spent had it remained with its citizens in terms of economic and social benefit.

My experience leads me to the view that this situation occurs but rarely.