UNITED NATIONS

ST

Secretariat

Distr.
LIMITED

ST/SG/AC.6/1997/L.7
7 May 1997

ORIGINAL: ENGLISH

GROUP OF EXPERTS ON THE
UNITED NATIONS PROGRAMME
ON PUBLIC ADMINISTRATION
AND FINANCE
Thirteenth meeting
27 May-4 June 1997

ENABLING PRIVATE SECTOR DEVELOPMENT: CHARACTERISTICS OF THE IDEAL POLICY ENVIRONMENT

Report prepared by the Secretariat*

CONTENTS

* In the preparation of this document, the Secretariat benefitted from the support of the Honourable Ms. Ruth Richardson, former Minister of Finance of New Zealand, who acted as a consultant.

CONTENTS (continued)

PREFACE

Setting the scene

United Nations embraces free markets

"There is a new universal understanding that market forces are essential for sustainable development. The role of the State is changing in most of the developing world, from one that seeks to dominate economic life, to one which creates the conditions through which sustainable development is possible. ... The United Nations has a vital role to play in supporting and preparing the ground for domestic and foreign private investment."

Secretary-General of the United Nations
World Economic Forum, 1 February 1997

What happens if a Government gets it wrong?

"Sound policies are absolutely essential. One of the most foolish things said about the international economy these days is that because capital moves so quickly and so freely, government policies have little influence. In reality, precisely because of greatly increased capital mobility, the difference between having the right and wrong government policies has never been greater. ... And just as good policies are rewarded more richly than before, mistaken policies are punished more severely."

Lawrence Summers on Mexico
The Economist, 23 December 1996

The bottom line

"The bottom line on competitiveness is that national economic policies make a profound difference to economic growth in the medium term. Open markets, lean government spending, low tax rates, flexible labour markets, an effective judiciary and stable political system, all contribute to economic growth on a reliable and sustained basis."

Global Competitiveness Report, 1996

I. INTRODUCTION

1. The quality of a country's economic policy and the integrity with which that policy is implemented are crucial factors for its prosperity. Compared to these factors, natural resources are usually of strictly limited value to a country - a fact attested by the existence of many poor but resource-rich countries, and rich but resource-poor countries. Cultural factors such as the capitalist ethic and civic trust are much more important for prosperity than natural endowments, yet a poor policy framework will still prevent even the most promising cultural conditions from being realised in the best economic outcomes.

2. It is true that a rich country may often be able to "carry" a poor policy framework for a period of time before its underlying contradictions become too pressing and demand to be addressed, whereas a poor country with an inadequate policy framework more often and more rapidly reaches crisis point. But rich or poor, a country cannot indefinitely blame inferior economic performance on international trading conditions or other such factors.

3. At the end of the day - and no matter what the characteristics of an economy, prolonged low growth, high unemployment, high inflation and indebtedness are effectively political choices. For instance, a country with high unemployment resulting from inflexible labour market practices effectively makes a political choice to retain its unemployment level. That country could choose - as New Zealand has done - to tackle vested interests through liberalizing its labour market, but instead chooses to continue to engage in a conspiracy against jobs.

4. Over the past two decades a growing consensus has emerged as to what constitute good policy choices. At the micro-economic level, orthodox economics stresses the role of open and competitive markets in creating wealth. As the Secretary-General stated in his speech before the World Economic Forum, "market forces are essential for sustainable development". At the macroeconomic level, there is a recognition that monetary and fiscal policies should not be used in an activist sense to attempt to boost short-term economic activity, but instead should be conducted so as to provide a stable and predictable overall climate that does not compromise good medium-term private sector outcomes - monetary policy by targeting price stability, fiscal policy by running roughly balanced budgets over the course of the business cycle.

5. The New Zealand reforms took place under two Governments, starting in 1984, and in the course of 10 years transformed its economic performance. Few other countries have undertaken reforms of such mutual consistency. As the Organisation for Economic Cooperation and Development (OECD) put it in its latest survey of New Zealand: "While other OECD countries have pursued similar policies, few, if any, have done so in the context of such a coherent overall framework, stressing predictability, transparency and accountability."

6. The key principles driving the reforms included:

(a) The abandonment of current account balance as a direct objective of government policy;

(b) The abandonment of fiscal policy as a means of short-term fine tuning, and instead the adoption of a medium-term fiscal strategy aimed at controlling government spending and eliminating the deficit;

(c) The assignment of monetary policy to the sole objective of achieving and then maintaining price stability;

(d) An abandonment of the use of economic policy instruments for distributional objectives, and an acknowledgment that concerns over income adequacy, or over the distribution of income, are best addressed explicitly through the tax and benefit system;

(e) A new emphasis on the value of competitive markets and the role of the price system in the efficient allocation of resources;

(f) A determination to expose New Zealand business, where possible, to international competition, without subsidies, tariffs or other artificial barriers;

(g) A belief that the tax system should be as neutral as feasible between different types of activity;

(h) In all areas of policy, a concentration on the medium-term implications of policies rather than their short-term effects.

7. At the heart of the reforms was a recognition that resources had not been well employed in New Zealand, and that only by exposing industry to market forces and to much greater international competition could New Zealand's economic performance be transformed. There was thus an explicit philosophy of economic liberalism: free markets were seen as the chief engine of medium-term economic growth. There was also an appreciation that the excessive short-term focus of macroeconomic policies had been severely damaging to the economy. Monetary and fiscal policy needed to be brought under control, to support the growth objective.

8. While "market" economic thinking has gained in currency in recent times, economics has in fact long stressed the importance of markets involving private property and free exchange under the rules of contract. There are very good reasons for this emphasis. A market economy is based on the idea of mutual gain. It enables its participants to specialize in what they do best and voluntarily to trade their goods and services with others. If a transaction takes place voluntarily, clearly both parties to the transaction expect to gain by it, or it would not take place at all.

9. A market economy thus constitutes a social institution by which, through cooperation, numerous trades take place that are mutually beneficial to those concerned. In this process, prices play a crucial role. They summarize widely dispersed information on resource scarcities and consumer preferences. By following price signals, participants in a market have strong incentives to undertake activities that are of benefit to society as a whole.

10. The superiority of competitive markets, where prices are free to move in line with market signals, over heavily regulated markets or production by a bureaucracy is based largely on two key considerations - information and incentives. Information is held in a highly dispersed form in any economy (market or otherwise), but the price mechanism of a market economy allows it to make far better use of this information than is possible under central planning. And the more competitive the market, the greater the incentive on those producing and distributing the goods or service in question to do so efficiently and to keep costs down; in competitive markets, producers have a direct interest in satisfying the needs of consumers.

11. A competitive market allows a much greater variety of ideas and approaches to come into play than in the case of a heavily regulated market or monopoly. In the latter case, only the knowledge or ideas of a limited group of people will be tested. But where the market is competitive, a much greater degree of experimentation is possible. Bad ideas will not last long in a competitive market. However, good ideas spread through being seen, rewarded and imitated. And because market prices will tend to change in such a way as to offset shortages or surpluses that arise, competitive markets are the most efficient mechanism for ensuring resources are fully employed.

12. Essentially the same reasons that lead New Zealand to favour competitive domestic markets also lead the country to strongly favour free international trade in goods and services.

13. The intellectual case for free trade has been strong ever since David Ricardo pointed out, early last century, that two countries can each become better off by specializing in goods in which they have a comparative advantage and trading those goods with each other at a mutually satisfactory price.

14. An economy based on private property and market exchange does not, of course, imply no role for government. The Government has a crucial role to play in providing a sound legal framework so that transactions can be undertaken with confidence. Laws need to be clear and mutually consistent, and enforced through the courts efficiently, competently and with a minimum of corruption. It is a sad irony that while Governments around the world take on so many tasks for which they are unsuited, most do poorly on this most basic of functions. Governments also have a legitimate role in various areas of social policy, particularly in ensuring that high-quality educational opportunities are in reach of all its citizens.

15. In recent times, the resurgence of market liberalism worldwide and the evident failure of planned economies have led to numerous countries undergoing economic liberalization programmes. But in either the developed or developing world, no country has undertaken such an extensive programme of restructuring as New Zealand. As a result of the New Zealand reforms, few rich countries now possess a greater economic freedom or an overall economic framework more consistent with the tenets of mainstream economics. For that reason, New Zealand's recent economic renaissance is of relevance to rich and poor countries alike.

II. THE NEW ZEALAND REFORMS - AN OVERVIEW

16. Though a relatively rich country, New Zealand by 1984 had been reduced to "poor country status" by first world standards, as a result of poor policy choices. A heavily overregulated and inefficient domestic economy, high protective barriers, and inconsistent and irresponsible monetary and fiscal policies had led to New Zealand having the worst productivity growth rate and the worst economic growth per head of any country in the OECD.

17. By 1984 the country was also approaching crisis point, since the rapid build-up in government and overseas debt - another OECD record - had become unsustainable. New Zealand's exports, though growing more diversified, were still dominated by bulk unprocessed pastoral products - essentially a third world country's export base. The poor economic performance could no longer plausibly be blamed on external influences: the country had run out of excuses as an economy and the need for reform was undeniable.

18. One of the most distinctive features of the New Zealand reform programme was its concern with the concept of "government failure", as understood by theorists of the public choice school. In general, Governments can be expected to act in their own self-interest; there is no guarantee they will follow policies that maximize the overall welfare of their citizens.

19. In New Zealand there was a search among policy makers for institutional rules that would bind Governments, as much as possible, to sound macroeconomic policies, even when the short-run incentives of Governments are for unsound policies. Measures such as the Reserve Bank Act 1989 and the Fiscal Responsibility Act 1994 can only be understood in this context.

20. The key initiatives of the decade of reform can be summarized as follows:

(a) The floating of the New Zealand dollar;

(b) A series of measures to bring greater focus, discipline and transparency to government spending, including the State Sector Act, the Public Finance Act and the Fiscal Responsibility Act;

(c) Reform of social transfers with the aim of containing costs and concentrating government assistance on the needy;

(d) The Reserve Bank Act, conferring price stability as the primary goal of the central bank;

(e) The corporatization - and in many cases privatization - of State trading activities;

(f) The introduction of a flat-rate value-added tax (GST), cuts in marginal income tax rates, and a series of measures to broaden the tax base and eliminate anomalies in the tax system;

(g) Deregulation of the financial sector, including the abolition of exchange controls, the lifting of interest rate controls, the abolition of reserve asset ratio controls on banks and the development of a new regime of prudential supervision;

(h) The introduction of freedom to contract in the labour market through the Employment Contracts Act;

(i) The elimination of most direct subsidies to both pastoral and manufacturing exporters, the phasing out of import licensing and the substantial phased reductions in tariffs towards low or zero rates;

(j) Other deregulations, including the removal of a number of specific price controls, the liberalization of air services and coastal shipping, and the introduction of competition into electricity and telecommunications.

21. These reforms reflect in large part the framework for development espoused by the Secretary-General as he spoke before the World Economic Forum:

> The United Nations has established and is promoting a common platform for development action ... Our detailed work in this area has included assistance for public administration reform, for economic restructuring, for privatization programmes and for essential infrastructure, as well as the strengthening of legal and regulatory frameworks. We set the international norms and standards that make progress possible.

22. Some of these reforms are by no means unique to New Zealand. In many areas, however, New Zealand has been a pioneer. For instance, the Reserve Bank Act and the series of public sector reforms culminating in the Fiscal Responsibility Act show New Zealand to be a world leader. New Zealand has also achieved one of the freest labour markets of any OECD country, as well as the least distorted tax system.

23. There were two major waves of reform. An initial wave of rapid but uneven liberalization was undertaken by the Labour Government elected in 1984. A second wave of reforms, which included the liberalization of the labour market and the reining in of government overspending, removed the final major anomalies in the policy framework and set the scene for economic recovery. This final wave of reforms was undertaken in the first term of the 1990 National Government.

24. A crucial component of New Zealand's reforms was the strong commitment from key political players. The most successful periods of reform were characterized by a clear strategy among ministers and a consistent application of that strategy throughout the public sector. The poor performance of the economy and the powerful vested interests opposed to change meant that a sense of urgency was important in maintaining the momentum of reform. Also important was the placing of high quality people in key public sector positions, to ensure that the vision of the reformers was not frustrated during the implementation stage by a bureaucracy resisting change.

25. Effective communication of the rationale for the reforms was crucial. Business needed to understand the reform strategy so as to be in the best position to realize its benefits. And a sufficient percentage of the public

needed to be persuaded to give reform the benefit of the doubt during a testing initial period when the adjustment costs outweighed any tangible benefits. Securing the support of key private sector groups to the cause of reform was an important factor in securing public acceptance of the liberalization programme.

26. So too was the overall resolve of the Government: as the reforms proceeded, sector groups typically gave up demanding to have their privileges restored and instead started urging the Government to treat them evenhandedly by moving to reform those sectors that were not yet liberalized.

27. After coming through the difficult initial period, the New Zealand economy has now performed so robustly that the reforms have been described by the OECD as "remarkably successful". Since economic recovery began in 1991, growth has averaged between 3 and 4 per cent per annum; unemployment has fallen to 5.9 per cent (one of the lowest rates in the OECD); and the Government's budget has swung into surplus, allowing taxes to be cut while simultaneously paying off all government overseas debt.

28. Private sector investment has been expanding. New Zealand's credit rating has been upgraded. The export sector is today much more diversified and sophisticated than prior to reforms. Surveys such as that of the World Economic Forum have placed New Zealand among the leading nations for competitiveness. And the German anti-corruption organization Transparency International has named New Zealand the least corrupt country out of 41 it surveyed - a reflection both on its culture and on the degree of economic freedom now possessed by New Zealanders.

29. With all these favourable outcomes, it is no wonder that the Financial Times stated that "New Zealand has demonstrated that orthodox economic reforms, energetically executed, can make a difference to an economy's prospects. For this reason, it offers important lessons"; the most important of these lessons are:

(a) The value of comprehensive reform. The New Zealand reforms were both micro-economic and macroeconomic. They encompassed capital and labour markets, goods markets and the government sector;

(b) The importance of balance in reform. The New Zealand economy began its period of sustainable economic growth only after the last principal obstacles to growth (namely an inflexible labour market and government overspending) had been effectively tackled;

(c) The value of a medium-term focus. All New Zealand's principal reforms had such a focus;

(d) The value of political commitment, a clear strategy and high-quality implementation by key people;

(e) The importance of effective communication and a sense of urgency in reform.

III. THE QUEST FOR SUSTAINABLE DEVELOPMENT: GETTING THE CRITICAL POLICY CHARACTERISTICS RIGHT

A. Role of monetary policy

30. It is a well-established empirical finding that over the medium term monetary policy can only favourably be used to influence the level of prices. Relaxing monetary policy in order to boost growth or employment can only work, if at all, in the very short run. Eventually the expansionary effect evaporates and the looser monetary policy flows through into inflation - which itself has harmful economic effects. For this reason, there is a growing recognition worldwide that monetary policy should be aimed simply at maintaining price stability and should avoid erratic swings that exacerbate the business cycle.

31. However, the fact that monetary policy can have a short-term favourable impact on activity presents a problem for the institutional design of monetary policy. Many politicians - and especially those in democratic countries facing periodic re-election - have notably short-time horizons. There is often a temptation for politicians to relax monetary policy, since the adverse effects of such an initiative are largely delayed until a future time.

32. Moreover, the problem is not solely one of how to constrain the worst instincts of politicians. Even if the monetary authorities are responsible, they still have to convince the private sector that they will act responsibly, when the private sector knows the authorities have a short-run incentive to inflate. Managing private sector expectations is important, since the more confident is the private sector that monetary policy will be aimed at price stability, the lower will be risk premium in interest rates.

33. New Zealand's solution to this problem was to give its central bank operational autonomy, combined with a statutory mandate for price stability. The Reserve Bank of New Zealand Act 1989 specifies stability in the general level of prices as the primary function of the bank. A public "Policy Targets Agreement" must be agreed between the Reserve Bank Governor and the Minister of Finance. The Bank has day-to-day autonomy.

34. However, twice-yearly it must produce a detailed monetary policy statement, which is tabled in parliament and examined by a parliamentary select committee. A Government can temporarily direct the Reserve Bank Governor to conduct monetary policy in accordance with an aim other than price stability, but such an action (which is most unlikely to occur) must again be transparent: any such "override" would need to be tabled in parliament.

35. The public nature of the override, combined with the open nature of New Zealand's capital markets, makes it unlikely the override will be used. A loose monetary policy only succeeds in boosting activity in the short term if it "fools" participants in the economy into thinking that there has been an increase in real demand for their services when there has only been a paper increase in demand. In a public override this "surprise" effect is mitigated.

36. All in all, the single objective, transparent contracting and explicit accountability mechanism of New Zealand's Reserve Bank Act represent a strong

institutional commitment to price stability. By making that commitment, the Act adds to the credibility of monetary policy and lowers the inflation risk premium built into interest rates.

B. International perspective on monetary policy

37. Internationally a politically and operationally independent central bank is the exception, not the rule. In too many cases, Governments view monetary policy as a convenient weapon to be wielded when the fiscal going gets too tough. In a highly damaging fashion, Governments have often resorted to an attempt to inflate their way out of their difficulties.

38. In an effort to mend such disreputable ways a number of strategies have been employed to win greater credibility in the fight against inflation.

39. Argentina has embraced the concept of convertibility; a fixed peg of the peso against the United States dollar. In effect Argentina conducts its monetary policy by proxy - i.e. it relies on the United States Federal Reserve to conduct its monetary policy.

40. While Argentina will eventually have to graduate to its own home-grown monetary policy, as a transitional stance a convertibility policy has helped to build credibility. In direct contrast it is very hard to build credibility when, as in a country like El Salvador, the governor of the Central Bank is also a member of the Cabinet.

41. Winning credibility in the conduct of monetary policy is not just a problem that developing countries wrestle with. The European Monetary System (EMS) is in effect a signup by participating nations to the monetary policy of the German Bundesbank. As the spectacular exit from the EMS of Italy, the United Kingdom and others on "Black Wednesday" in 1992 demonstrated, external norms cannot survive in the face of contrary domestic policy settings.

42. Countries rich and poor are debilitated by high inflation. But high inflation steals in particular from the poor and those on low and fixed incomes. Given that there is a high degree of correlation between central bank independence and low inflation, it makes sense to move to New Zealand's highly creditable model.

IV. CEMENTING RESPONSIBLE FISCAL POLICY

43. Fiscal policy represents a similar - though more complicated - challenge of constraining government so that its conduct of policy is consistent with sound medium-term objectives. Persistent budget deficits harm savings and investment and compromise the long-run growth of its economy in favour of immediate consumption. Yet public ignorance, the short-time horizons of politicians, and the nature of the political lobbying pressures to which Governments are subject, all conspire to produce frequent overspending and fiscal deficits.

44. This suggests that countries need an institutional mechanism for entrenching, as far as possible, responsible fiscal behaviour over time. But overly simplistic fiscal rules - such as a requirement for the Government to balance its budget each year - suffer from a variety of theoretical shortcomings and do not have a good record in practice.

45. New Zealand's solution to this problem was the Fiscal Responsibility Act 1994. This Act establishes a statutory framework for the responsible conduct of fiscal policy, and seeks to reverse the institutional and political bias that leads over time to increasing government spending and debt-financed fiscal deficits. It is designed to achieve for fiscal policy what the Reserve Bank Act has achieved for monetary policy.

46. There are two essential elements to the legislation. The first is a set of principles of fiscal responsibility, which provide explicit guidelines for the prudent conduct of fiscal policy. These principles include running balanced budgets "on average, over a reasonable period of time" (i.e. over the course of the business cycle), reducing government debt to prudent levels, and pursuing policies consistent with a reasonable degree of predictability in future tax rates. These principles do not constrain an elected government from making a full range of expenditure decisions in line with its social priorities.

47. Under the Act, a Government is still free to specify the broad strategic priorities by which it will be guided in preparing the budget. It can - and should - advance its economic and social policy ambitions. But the existence of the fiscal principles does ensure that a Government's objectives will be pursued in a fiscally responsible manner.

48. The Fiscal Responsibility Act also recognizes that Governments may on occasion be forced temporarily to depart from the principles of responsible fiscal management. However, when it does so, a Government must justify this departure and outline how it intends to return to policies consistent with the principles of responsible fiscal management.

49. Just as important as the principles to ensure responsible fiscal management is a commitment to fiscal openness. The Act is designed to ensure a high degree of public and parliamentary understanding of the parameters within which the budget is being prepared. At least three months before the start of the fiscal year, the Minister of Finance publishes a Budget Policy Statement - a strategic document setting out the Government's broad priorities for fiscal policy.

50. Thus, the Act exposes to parliamentary scrutiny and private contestability the basis on which the Government is preparing the budget before it is finalized. This leads to a wider sense of ownership of the budgetary issues that the Government must address.

51. The Act also requires a detailed set of three-year economic and fiscal projections to be published at budget time, along with an assessment of fiscal policy in the context of the principles of responsible fiscal management. It further requires a second set of three-year economic and fiscal projections to be published halfway through the fiscal year.

52. In addition, the Act requires a full set of three-year projections to be published just prior to a general election, so as to enable all political parties and the wider public to debate issues and to advance policy with the best possible information on the state of the country's books. The temptation for political parties to engage in an electoral auction in the run-up to an election is greatly reduced when the true state of the Government's books must be disclosed prior to an election.

53. The principles of fiscal responsibility in the Act, together with the high level of fiscal disclosure, provide strong incentives for Governments to operate fiscal policy in a responsible manner. The Act has already helped change the nature of political dynamics and the wider policy debate: the current coalition government wishes to be seen as "fiscally responsible" in terms of the legislation, while the private sector regards compliance with the Act as a key aspect of responsible economic management.

54. The Fiscal Responsibility Act, in conjunction with the Reserve Bank Act, has given New Zealand what Economist magazine has described as "the world's best" fiscal and monetary policies.

A. Global experience in managing fiscal pressures

55. Governments around the world are plagued by debt and deficits. In some cases the culprit is a political unwillingness to face up to a decline in the nation's earning power. Those nations will typically live beyond their means, borrow and hope to postpone the day of reckoning for as long as possible. Debt is the disreputable legacy for the next generation, and increasingly a blight on current performance.

56. In other cases, typically in the developed Western world, the rate of increase in special entitlements is outstripping those nations' capacity to pay. External disciplines such as compliance with the Maastricht Treaty demands or crude balanced budget amendments are employed in an endeavour to bring these nations into line on the deficit.

57. Deficit and debt difficulties of a completely different order of magnitude are experienced by the world's lamest economies where the starting point is decades of abysmal performance. Yet the economic imperatives are the same.

58. High rates of domestic savings are essential for sustainable development. The first and worst sinner when it comes to savings is generally the government of the day, which has been typically "dis-saving" for generations. In the quest to secure macroeconomic credibility, so essential for the flow of foreign capital, sound monetary policy must be matched by the practice of fiscal responsibility.

59. In an open market economy the sanction for a policy lapse on either count is swift and savage.

B. Transforming the public sector

60. As stated in a 1995 OECD report, "Governance in Transition: Public Management Reforms in OECD Countries", a variety of factors have come together to make reform a burning issue. Key among these are:

(a) The development of a global market place, which highlighted the impact of government activities on national competitiveness;

(b) A perception that public sector performance was inferior to that of the private sector;

(c) Concern that the public sector was squeezing out the private sector;

(d) Limits to future growth of the public sector, given budget deficits and high levels of public debt;

(e) A lowering of expectations about government's ability to solve economic and societal problems by traditional remedies;

(f) Citizens' demands for improved responsiveness, choice and quality of service;

(g) Demands from public service staff.

61. Put together, these pressures have resulted in a reappraisal of the rationale for government intervention and a re-examination of public sector management and performance.

62. Many countries around the world are coming to appreciate the shortcomings of the institutional environment under which government bureaucracies have often operated. Objectives are often confusing or conflicting, accountability is weak, incentives for efficiency are minimal, and management is hamstrung by overcentralized decision-making and excessive bureaucratic rules.

63. In this environment, resistance to change typically becomes endemic, and the bureaucracies are run as much for the benefit of public sector workers as for serving the interests of the wider public. Such a self-serving public sector certainly characterized New Zealand prior to its economic reforms.

64. Reforms start with a first rethinking of the principles of the entire role of the State. Over time, Governments become greatly over-stretched: they undertake many activities where they have no legitimate role and generally end doing badly those things that do constitute its core functions.

65. The task facing reformers is to decide upon those areas where the State has a legitimate role, then determine in each instance how that role can be most efficiently and effectively carried out. This inevitably means a reduced government presence in the economy, as well as a transformation in how the State undertakes its remaining functions.

66. Typically, the State's roles include regulating private sector activity, producing many goods and services itself, and providing social services. In truth the State is often both player and a referee. It should confine itself to the referee or regulator function. As regulator, the State takes on a much less obtrusive role through its core function of setting the legal framework against which open and competitive markets can operate. This remains, of course, a quite crucial function of government. The ideal is to combine generally sound law with an uncorrupt, independent and relatively competent judiciary, and thus to score highly as an economy where the rule of law is upheld.

67. A Government should also reduce its role as a participant in economic activity through corporatizing and privatizing many State trading activities. As concerns the provision of social services, by contrast, most changes have concerned how the Government discharges that function, rather than involving a reduction in the overall government presence.

68. A decade of reforms to New Zealand's public sector has led to a model of public sector management that has brought world acclaim. The new public sector model starts at the strategic level, where cabinet ministers decide on their key priorities. As the only participants with democratic legitimacy, ultimately it is the ministers who can set the desired social and economic outcomes that are to result from government action.

69. Each year a document is produced setting out the Government's vision of the outcomes it wishes to see achieved in the years ahead. In advance of the presentation of the budget the Government also publishes a Budget Policy Statement - another strategic document incorporating the Government's economic and social ambitions. This document binds the whole of the Government to the published strategy.

70. In line with the strategy, individual ministers in turn choose the outputs they wish to purchase from their departments and from other State entities in order to help realize the outcomes sought by government. The chief executive of each department is responsible for providing the relevant minister with the contracted outputs. The chief executive is on a fixed-term contract and has wide discretion to manage departmental inputs - including labour.

71. Labour practices are flexible, with unionism voluntary and a large percentage of State sector workers covered by individual contacts (as is also the case in the private sector). Pay-by-performance is commonplace. Often tasks are contracted out to private sector organizations that can perform the function more efficiently; there is no presumption that Government is the preferred provider.

72. Besides purchasing outputs, the Government also has an "ownership" interest in the assets tied up in government agencies. In the core State sector each department must now calculate a balance sheet, and a system of capital charging has been introduced. These twin disciplines provide a powerful incentive for departmental chief executives to manage their balance sheet and to make the most efficient use of their assets.

73. It is, however, in the area of State trading activities where the Government's ownership interest has been most radically reassessed. Prior to the reforms, most trading activities were contained in government departments, which faced poor incentives, bureaucratic controls and often mixed objectives. Service was notoriously poor, and many activities ran permanently at a loss. Under the reforms, these activities were separated out into distinct organizations, becoming State-owned enterprises (SOEs).

74. SOEs are registered under the Companies Act and are required to operate in most respects as private companies. They have a clear profit objective and boards that are largely free from political control. They must borrow on their own account and pay tax and dividends to the Government. Nor are they shielded from facing private sector competition. Day-to-day running of an SOE is in the hands of its board and management. The shares are held by two share-holding ministers. The sole task of the share-holding ministers is to manage the taxpayer's ownership interest by appointing the board, setting dividend policy, and monitoring overall performance.

75. Under the improved incentives provided by the new regime, there were some huge productivity increases following corporatization. New Zealand Telecom, the new communications SOE, almost doubled its productivity; the new coal SOE managed to cut its total workforce in half during its first year in operation while increasing output; and the railways reduced its staff numbers by almost two thirds over a four-year period while carrying increased tonnage. These efficiency gains were not captured by the corporations themselves; they were passed on to consumers in the form of lower prices and - frequently - better services:

(a) Electricity prices fell by 13 per cent; telecommunications prices fell by around 20 per cent, as did coal prices; rail freight rates were halved; the price of posting a standard letter fell substantially over time; while the new port companies also achieved major reductions in prices;

(b) Almost all the SOEs became more customer-focused than their predecessor organizations had been. For instance, the average waiting time for installing a new telephone came down from six weeks to two days.

76. There were also benefits for the taxpayer. The great majority of SOEs soon ran as profitable businesses, in some cases reversing years of loss making. As a group, the SOEs increased their return on shareholders funds by around 75 per cent in just one year. Through their tax and dividend payments, they became a significant source of revenue to the Government.

77. While these developments were welcome, in the case of the great majority of SOEs there were strong economic reasons for taking the further step of transferring the business to the private sector. Only in the private sector would productivity be maximized, and each business best placed to undertake new investment.

78. Corporatization was a halfway house, and the performance incentives and monitoring mechanisms under government ownership - while much improved - still

did not match those available in the private sector, where shares were freely tradable and companies subject to takeover.

79. State-owned businesses also carry a genuine risk of policy slippage over time. Political fashions can change, and commercial considerations can easily become increasingly subordinated to political considerations once again, given the often short-time horizons of the political process. The slow infiltration of politics into SOE policy can be manifested in terms of soft required rates of return, interference in key decisions such as pricing, or excessively political board appointments. For all of these reasons, a major privatization programme was undertaken in New Zealand.

80. A successful privatization programme will have clear objectives and a well understood process for conducting the sales. In New Zealand the objective was to maximize the value of each asset sale to the taxpayer. Other objectives - such as a desire to spread popular capitalism or to redistribute income from one group to another - did not play any substantial role.

81. Thus in New Zealand an economically pure approach was taken. By seeking to get the best possible price for each asset, not only were the interests of the taxpayer directly served, but the wider interest of economic efficiency was also served, since those purchasers who are prepared to pay the highest price are, in general, those in the position to use those assets in the most efficient manner.

82. In New Zealand it was considered important, in any asset sale, for the regulatory framework of the relevant industry to be satisfactorily resolved before the sale took place. This gives maximum certainty to all the players involved. Nor was the mistake made of selling off State monopolies in such a way that they merely became private monopolies.

83. Deregulation and contestable markets were becoming the norm under the New Zealand economic reforms. Where an industry had some characteristics of a natural monopoly, the preferred approach was still one of contestable markets (as far as possible) allied to light-handed regulation.

84. Like the regulatory environment, legislative authority for an asset sale should be completed before the formal sale process gets under way. If the Government is seeking to maximize the price received, it should avoid attaching arbitrary conditions in legislation that may have a political motive, but which devalue the sale process. If a large number of assets are being privatized, generic legislation is desirable. In New Zealand's case, all the SOEs had been set up under the State-Owned Enterprises Act 1986. Since, under the Act, the Government held the shares in these companies, selling those shares to the private sector required no new legislation.

85. Once a sale gets under way, the transparency and the integrity of the process are important to maintaining confidence. The sale process should be run in as commercial a manner as possible. The maximum feasible amount of information should be provided to bidders. The sale should not be tied down to a fiscal timetable. If an asset is being sold so as to "improve" one year's fiscal numbers, it is being sold for the wrong reason.

86. Such an approach risks leading to rushed sales, mistakes in the sale process and compromises on price. For that reason, the Minister of Finance deliberately did not write the projected proceeds of asset sales into any fiscal forecasts. All proceeds from asset sales were dedicated to retiring debt.

87. In New Zealand's privatization programme, assets totalling around $14 billion were sold. Most sales were by open tender, and many assets went to overseas interests.

88. The wholesale separation of commercial functions from other functions of government departments in New Zealand has been one aspect of an overall programme of restructuring the public sector so as to make objectives and accountability more unambiguous. Thus the provision of policy advice has typically been separated from the operational functions of departments, partly so as to remove any conflict of interest from those involved.

89. For similar reasons, the funding of activities has been separated from their provision. Regulatory functions have also been isolated into separate agencies. In any given area of policy, there is likely to be a small ministry giving policy advice and other agencies acting as purchaser or provider. Almost the whole of the public sector has been restructured along these lines.

90. Any Government that takes seriously its role as purchaser of outputs and as owner of assets will put in place sound systems to measure performance. Here, too, the New Zealand public sector model leads the world. Information requirements right through the public sector are substantial. In line with the new stress on outputs, all departmental reporting and financial accounting is on an output basis.

91. At the aggregate level the New Zealand Government now calculates an annual operating statement on an accrual basis, as well as a consolidated balance sheet for the whole of the State sector - the only country in the world to do so. Fiscal projections are also open and transparent. By law the Government must produce and publish twice-yearly economic and fiscal projections, including a set of forecasts just prior to each general election.

V. INTERNATIONAL TRENDS TO REINVENT AND MODERNIZE GOVERNMENT

92. The quest to modernize the State has swept the world. All nations whether rich or poor want government that "works better and costs less". Reform approaches range from the radical (New Zealand) to the innovative (United Kingdom's Next Steps) to the incremental (much of Europe, Latin America and Asia).

93. The distinguishing feature of New Zealand's approach is its comprehensive nature - the reforms cover the whole of government, including the core State sector. In contrast, the United Kingdom's reforms created a series of agencies out of those parts of traditional departments that were providing services to third parties. The core of the United Kingdom's government administration is only just embarking on human resources and financial management reform.

94. Malaysia has undertaken a public sector management reform programme in a more incremental way, by seeking to move the focus to results. A client charter concept is being introduced that promotes total quality management and consultation with the public about the standards of service provided.

A. Accountability, predictability and transparency

95. The New Zealand public sector reforms rate highly on three important principles of good governance - accountability, transparency and predictability. Accountability in New Zealand has been enhanced at all levels. Departmental chief executives are now directly accountable for their performance in delivering their department's outputs, and even ordinary employees are more accountable than under the old union-dominated State sector.

96. The outputs of a department are now clearly specified. Both ministers and the wider public can see what they are buying, how much it costs, and who is responsible. Privatized SOEs now face the disciplines of the competitive marketplace. Those SOEs that for various reasons have not yet been privatized still face much increased accountability: share-holding ministers seek an economic rate of return on the taxpayer's assets and are empowered not to reappoint directors after their terms have expired.

97. There are other means by which accountability in government can be strengthened. Free and open financial markets are an important ally of good government. They sit on daily judgement over a country's economic policy and bring home to a Government visibly, and rapidly, the medium-term consequences of poor policy.

98. Where asset prices appear misaligned, they usually reflect underlying imbalances in economic policy. By so doing, they put pressure on policy makers to address those imbalances. In New Zealand the liberalization of exchange controls and interest rate controls in the mid-1980s, along with the clean float of the New Zealand dollar, played an important role in encouraging Governments to adopt prudent policies, especially in the area of fiscal and monetary policy.

99. The New Zealand model rates equally highly in terms of transparency. Clear operating rules and a free flow of information assist economic decision making, reduce uncertainty and increase confidence in the legitimacy of a Government (whether democratic or not). New Zealand has an Official Information Act policed by an independent Ombudsman. That legislation sets down the general principle that information should be made available in the absence of compelling reasons otherwise. Crown-owned entities report regularly to Parliament, while New Zealand's fiscal reporting is the fullest in the world. The Government's overall fiscal strategy must be disclosed in accordance with the requirements of the Fiscal Responsibility Act.

100. Other important arms of economic policy typically operate also under substantial transparency requirements. It has been noted, for instance, how the Reserve Bank Act sets down a highly transparent framework for the conduct of monetary policy.

101. Where policies are transparent and accountable they are likely also to be predictable in their impact. Thus it is in New Zealand. Monetary policy furnishes a good example: the operational autonomy of the Reserve Bank, its single and explicit objective, and the transparent contracting between Government and Bank lends policy a high degree of predictability.

102. Similarly, the transparency and medium-term focus of New Zealand's public sector management model lend increased predictability to fiscal policy. The requirement in the Fiscal Responsibility Act to run a balanced budget over the course of the business cycle, along with the high level of information disclosure required by the Act, is an explicit mechanism for entrenching over time sound fiscal outcomes.

B. Taxation

103. All taxation imposes substantial indirect costs on a community, over and above the direct costs of the taxation. These indirect costs largely arise from the reduced incentive to work, save and invest resulting from the imposition of tax. The principal question of tax design is how to minimize these costs. A soundly-designed taxation system will have low rates of taxation applied over a broad tax base, and except where compliance costs make it infeasible, it will generally avoid applying a different rate of tax to different economic activities.

104. A selective tax system encourages tax-driven investment. This is contrary to the welfare of the community as a whole, since certain investment decisions will proceed, not because they have a high economic return, but purely because of their tax advantages, while other investment opportunities will in comparison be arbitrarily penalized. A well-designed tax system will also avoid high marginal tax rates, since these lead to high losses in terms of foregone economic activity.

105. As well as involving sound tax design, tax laws need to be competently and consistently enforced by the agency responsible for collecting the tax. If that is not the case, the economic consequences will be as serious as badly designed tax laws. Enforcement will be easiest in countries where there is a culture of compliance with the law, but the incentives for corruption and tax evasion will be highest when tax rates are highest - another reason why law tax rates applied over a broad tax base is a sound tax strategy.

106. Prior to the economic reforms, the New Zealand tax structure had been poor by the standards of other OECD countries. It was heavily reliant on direct rather than indirect tax, contained numerous loopholes and, unsurprisingly, had resulted in very high marginal rates of direct taxation. The tax system discouraged work effort and greatly distorted investment decisions. In the course of the economic reforms, the balance of the tax system was shifted more towards indirect tax, loopholes were progressively closed, and marginal rates of income tax were lowered substantially.

107. The centrepiece of the tax reforms was a flat rate value-added tax, levied on virtually all goods and services. The Goods and Services Tax (GST) replaced

the existing varying-rate sales tax and allowed marginal rates of income tax to be substantially cut. Difficult to evade, easy to comply with and even in its incidence, GST proved a model of tax reform. Other reforms were also made to broaden the tax base and eliminate loopholes in both company and personal tax. Already by 1989, the OECD was calling New Zealand's tax system "probably the least distorted in the OECD".

C. Reforming the labour market

108. Poor labour market outcomes - particularly in the form of unemployment - constitute one of the most serious problems facing many Governments today. Yet unemployment is not an insoluble problem: orthodox economics tells us how to go about combating it and which misconceptions to avoid. A mistake too often made is to view the labour market as somehow fundamentally "different" from other types of market.

109. The labour market certainly has special characteristics, but the similarities between labour markets and other types of market are of much greater significance than the differences. The same reasons that lead mainstream economics to favour open and competitive markets also provide powerful arguments for flexible labour markets with a minimum of regulation.

110. Like any other, the market for labour services involves a common interest between buyer and seller. The buyer of labour services is the employer, the seller is the worker. Their common interest is best met by maximizing the potential for voluntary cooperation between them. Both parties have the information and the incentive to maximize the benefits from any agreement.

111. At the same time, the interest of society as a whole is best met by ensuring competition between employers for the hire of workers and between workers for employers. This maximizes the chances that labour resources will be put to their most productive uses.

112. Accordingly, the key principle should be the widest possible freedom to contract in the labour market. The worker may choose to contract directly with the employee, or he may delegate the task of negotiation to a union. That is up to the parties involved. But the State should not arbitrarily restrict the types of contracts that individual workers and individual employers can enter into.

113. A labour market with a high degree of freedom to contract will have major benefits in terms of productivity, industrial harmony and job satisfaction among employees, but the greatest advantage of a liberalized labour market is its implications for unemployment. A liberalized labour market will keep involuntary unemployment to a minimum.

114. There will always be some degree of frictional unemployment, consisting of those workers who are currently between jobs and searching for work, but so long as labour is reasonably mobile, and so long as there is genuine freedom to contract, workers will before long be able to find buyers for their labour.

115. There is a considerable evidence that flexible labour markets lead to both higher economic growth and lower unemployment than highly-regulated labour markets. The East Asian economies have some of the most flexible labour market regimes in the world and have combined low unemployment with spectacular economic growth and rapidly living standards.

116. The superior flexibility of the United States and British labour markets, in comparison to most continental European labour markets, is widely admitted to be a major factor behind the lower unemployment rates of those countries.

117. Yet despite these examples, many countries' labour markets remain heavily overregulated. Laws ostensibly designed to "help the worker" typically put barriers in the way of job creation. Some of these laws - such as minimum wage laws - directly freeze marginal workers out of the workforce.

118. Other laws can give unwarranted power to certain insiders, who can then use their powers to marginalize the more vulnerable members of the labour force. The persistence and the scope of such laws are largely responsible for unemployment being almost a worldwide phenomenon.

119. Until recently, New Zealand provided a good example of misconceived labour laws. In New Zealand, every worker was covered by a national award setting out the wages and conditions to which they were entitled. The award was negotiated in an annual ritual between the worker's union and representatives of the larger employers, and was then binding on employer and worker alike. Union membership was compulsory, and there was only one union available for any given worker to join.

120. The drawbacks of the regime were not hard to see. Each workplace is unique, yet the same award applied to widely disparate workplaces. Instead of leaving decisions to those best placed to reach agreement on wages and conditions of employment, i.e. workers and employers at the level of the firm, decisions were made by third parties remote from the action. In the process, the scope for many potential productivity improvements was compromised. Good employers were frustrated because they could not innovate through reaching no-strike agreements, making more intensive use of the plant, or developing more flexible remuneration structures.

121. Unions had a monopoly on worker representation, which reduced their incentives to work in the best interests of their members. And the award system was a wage-setting cartel for employers just as much as for workers. As for the unemployed, their interests were not represented in the system at all: they were prevented by law from offering themselves on the labour market on terms and conditions they thought fit.

122. New Zealand's industrial relations system was thus characterized by monopoly behaviour by the "insiders" of the system, at the expense of outsiders. The manner in which it pitched employers against unions in award negotiations led to a strong "adversary" culture between employers and unions. The fundamental common interest between employer and worker was often forgotten.

123. By 1991, when the wider economic reform programme had been under way for six years, the imperative to address the labour market had grown. The vehicle for reform was the Employment Contracts Act (1991) - legislation that represented a radical break from the past. With some exceptions, it ushered in a new era of freedom to contract.

124. Under the Employment Contracts Act, there is very little proscription of the types of contracts employers and workers can enter into. Workers can be covered by a collective contract or by an individual contract. Employers can negotiate a mixture of collective contracts and individual contracts with their workforce. Union membership is no longer compulsory. A worker is free to choose his or her own bargaining agent when negotiating with their employer.

125. Strikes are seen by the Act as a breach of contract and are only permitted where they relate to the negotiation of a collective contract for the employees concerned. All other types of strike - including sympathy strikes - are unlawful. While both collective contracts and individual contracts are permitted under the Act, it does not favour one type of contract over the other. The essence of the Act is choice. Whether to have a collective or an individual contract is itself a matter for negotiation between employer and worker.

126. There are, admittedly, some areas where the Act did not go far enough towards free contracting. One of these is the statutory minimum wage, which the Act failed to repeal. Another was the Act's retention of a specialist legal institution for labour issues. Despite these important limitations, the performance of the New Zealand economy since the Act came into force has exceeded even the expectations of the Act's strongest proponents.

127. The economic upturn began the very next quarter, and New Zealand has enjoyed uninterrupted growth since that time. While its precise impact on the upturn can be debated, the Act was undoubtedly the major factor ensuring that the economic upturn flowed through so strongly into job creation. When the Act came into force, unemployment was nearly 11 per cent. Five years later, the rate is 5.9 per cent. Thus, over a period when unemployment has risen in most OECD countries, New Zealand unemployment fell substantially, and the number of jobs increased by over 230,000, or almost 16 per cent.

128. None of the fears voiced about the Act turned out to have substance. The new regime did not lead to greater industrial disruption: there was a sharp drop in the number of working days lost through strikes. Nor did it lead to cuts in wage rates. There is ample evidence the Act has led to a positive change in the culture of New Zealand workplaces. In 1993 a survey by the New Zealand Institute of Economic Research found that 47 per cent of businesses believed the Act had improved labour productivity in their enterprise; 63 per cent believed it had led to increased flexibility of operations; 29 per cent believed it had led to increases in staff training, while 37 per cent believed it had improved the quality of management. Other surveys have shown similar results.

129. As for employees, a survey last year found that over 75 per cent of the labour force were satisfied with their terms and conditions of employment, their employers and their jobs. There has been a big shift over this period towards

individual rather than collective contracts. Union membership has fallen substantially, but unions have not disappeared from the industrial scene. They are simply having to earn their memberships by providing a service, just like any other voluntary organization.

130. In sum, the economic outcomes of the Employment Contracts Act have borne out orthodox economic theory and have demonstrated that high quality labour market reform is not only possible, but can also be politically durable.

D. Capital markets

131. Free and lightly-regulated capital markets assist economic development by allowing capital to be allocated to its most efficient uses. The rapidity with which financial markets were liberalized early on in the reform programme was a particular feature of the New Zealand reforms. All controls on interest rates were lifted almost immediately, and all exchange controls abolished. The system of reserve asset ratios applying to financial institutions was abandoned.

132. Monetary policy henceforth operated, not by direct controls on individual banks, but by controlling the amount of base liquidity in the total financial system. Any legal distinction between banks and non-banks was removed. Banks receive no government guarantee, but are subject to prudential supervision by the Reserve Bank and light-handed regulation.

133. In March 1985 the New Zealand dollar was floated. Ever since then, the Reserve Bank has run a "clean" float: there has been no buying or selling on the foreign exchange market with the intention of directly influencing the value of the New Zealand dollar. The Reserve Bank is not indifferent to the level of the exchange rate, since it constitutes one of the important mechanisms through which monetary policy is transmitted, but there is no exchange rate target. The Reserve Bank monitors a range of indicators in assessing monetary policy, of which the exchange rate is one.

134. Floating the currency had two principal rationales. It assisted monetary policy by giving the authorities better control over the monetary base than is possible under a fixed exchange rate regime. Moreover, as with any other price in the economy, there were sound theoretical reasons for wanting the exchange rate to be free to move in response to underlying changes in supply and demand.

135. Like other prices, it is a mechanism through which important signals are transmitted to participants in the economy. At least under a balanced policy framework, a floating exchange rate has a role of its own to play in efficient resource allocation.

136. The floating of the exchange rate was certainly successful in gaining independence for New Zealand monetary policy. In the early years of the reforms, however, it is at least arguable whether floating the exchange rate assisted overall resource allocation. This was because of the imbalances elsewhere in the reform programme - particularly the large fiscal deficits which persisted for some years. These deficits often put upward pressure on the real exchange rate, to the detriment of the export sector.

137. For most of its history, New Zealand has had a relatively liberal regime governing inward direct investment. However, on the strength of the economic reforms, New Zealand has become a much more attractive destination for foreign investment than formerly. Between 1989 and 1994, the stock of foreign direct investment more than tripled to around one quarter of GDP. A large percentage of New Zealand's major corporates are now foreign-owned.

138. The Government encourages foreign direct investment and sees it as an important means by which New Zealand can gain new technology, skills and market linkages. Investment was flowing into the country well before the overall economic upturn in 1991 - a clear sign that it was attracted by the new policy framework being developed. Foreign investors have also come to have a very substantial presence in the New Zealand bond market: the percentage of government bonds held by non-residents has risen from 8 per cent in December 1988 to 62 per cent in December 1996.

139. The lesson from New Zealand for other countries seeking capital is that foreign investment will follow a sound policy regime. In the case of developing countries, only 10 per cent of the capital they attract comes from donor organizations; the great bulk of capital is private investment. The global capital market is a reality, and the quality of a country's policy regime is a crucial factor in attracting that investment.

140. Developing countries can help themselves by accepting the need for greater openness. Transparency is essential to a well functioning capital market. Lawrence Summers put the case for transparency very forcefully in the context of discussing the lessons to be learnt from the Mexican financial crisis.

> Full disclosure will attract capital by reassuring the investment community. Moreover, it will promote market discipline, generating a faster response from private analysts and public institutions when trouble looms on the horizon. Most important, the discipline of disclosure fights policy makers' temptation to believe that they can somehow slip and slide their way through problems by making use of clever reporting.

<u>The Economist</u>, 23 December 1996

E. Assistance to industry

141. Governments cannot create wealth, but they can put in place an environment conducive to wealth creation in the private sector. This paper has described many of the elements of the environment favourable to the entrepreneur: a sound legal framework; stable prices; fiscal policy that does not damage private sector investment; a State sector that does not impose excessive costs on the private sector; a flexible labour market; open capital markets; and a competitive and deregulated economy.

142. Other attempts to more directly "help" the entrepreneur are usually self-defeating. Industry assistance in the form of subsidies or tax breaks to specific industries is almost always misconceived. Such assistance encourages investments that would not otherwise have been undertaken, but the fiscal cost

of such measures translates into higher interest rates or higher taxes, with the result that other - more favourable - investments do not take place at all.

143. This type of assistance will only be positive for an economy if the Government is consistently better at picking winners than the private sector. However, there is no reason to believe that the Government has better information than the private sector, and every reason to believe it has worse. Moreover, the incentives on Government are clearly inferior to private sector incentives.

144. Even less can industry assistance in the form of tariffs or other controls on imports be justified. Such policies dissipate some of the gains that a country can make through international trade. Import protection encourages inefficient import-competing industries to develop, while loading costs onto the export sector. It draws resources into activities in which a country does not have a comparative advantage, at the expense of activities where it does. This plainly lowers overall economic welfare.

145. In line with this thinking, both direct industry assistance and import protection have been greatly reduced in New Zealand in recent years. However, there is scope for them to be reduced even further.

F. Speed and sequencing

146. Speed is important in undertaking structural reform, and there is no evidence that slowing down the process of reform yields benefits. For instance in Eastern Europe, those countries that have pressed ahead rapidly with reform have done appreciably better as a group than those where reform has been tentative.

147. However, for political and other reasons, most reform programmes do take place in stages, and there are clearly better and worse sequences in which reform can be undertaken. In New Zealand, the sequencing was far from perfect. A general consensus on the optimal sequencing of reforms might be summarized as follows:

(a) Macroeconomic stabilization should, if possible, take place early. The Government should move rapidly to control the fiscal deficit. If not, poor macroeconomic policy will compromise the gains made in the microeconomic reforms;

(b) Domestic markets - both in goods and in labour - should be deregulated, as much as possible, no later than the reduction in border protection. This will provide import-competing industry with the environment most conducive to competitiveness, before exposing it to international competition;

(c) Financial market deregulation should not occur before substantial progress has been made in liberalizing goods and labour markets and before the fiscal deficit has been brought under control. This caveat particularly applies to the foreign exchange market: opening up the foreign exchange market too early risks putting excessive upward pressure on the real exchange rate;

(d) The broader the scope of the reform programme and the more clearly it is telegraphed, the sooner will the benefits begin to flow.

148. In New Zealand the sequencing of reforms went roughly as follows:

(a) Financial market liberalization - immediate;

(b) Goods market liberalization proceeded in stages, mainly subsequent in time to financial market liberalization;

(c) Government sector reform proceeded in stages, but fiscal imbalances were not finally corrected until late in the reform programme;

(d) Labour market liberalization - late.

Thus two principal mistakes in sequencing were:

(a) The long time taken to bring the government deficit under control, following deregulation of the financial markets (and in particular the foreign exchange market), which put excessive pressure on exposed sectors of the economy;

(b) The failure to liberalize the labour market early in the reform programme, which compromised the drive to become internationally competitive and resulted in excessively high unemployment during the transition. A third mistake was the uneven pace of goods market reform, in which assistance to exporters was scaled back more rapidly than reductions in import protection. For a time this put added pressure on the export sector.

149. These sequencing mistakes undoubtedly increased the adjustment costs of the New Zealand reforms. The biggest single mistake was probably the delay in implementing labour market reform - a mistake that had severe costs in terms of employment.

VI. CONCLUSIONS

150. The Secretary-General has spoken of the need for a new partnership between Government and the private sector. One can now summarize in what manner, on the arguments of this paper, that partnership should operate. On one side, the Government must provide a framework of policies that are consistent, transparent, predictable and credible. It should not attempt to perform tasks that are the proper province of the private sector, but should rather provide the overall climate within which markets can flourish.

151. Private sector participants, for their part, must be prepared to take the lead in investment decisions and look to their own skills and resources in the search for higher productivity, rather than seek to be rescued by government rules that confer privilege on them while raising costs on others. Private

sector participants must observe the legitimate rules of competitive markets and stay within the law.

152. A policy regime that has realized this partnership with a high degree of effectiveness would look like this:

(a) A monetary policy aimed at price stability, and an institutional mechanism - such as New Zealand's Reserve Bank Act - that effectively locks price stability into the economic framework;

(b) Fiscal policy that does not attempt to be actively counter-cyclical, but which aims to run balanced budgets over the course of the business cycle - preferably with an institutional mechanism such as New Zealand's Fiscal Responsibility Act as a means of cementing in good fiscal behaviour;

(c) A Government sector that is only performing those functions that could not more efficiently be performed by the private sector, and is undertaking those tasks in as transparent and accountable a manner as possible. Commercial businesses belong in the private sector;

(d) A tax system where low rates of tax are conferred over broad tax bases;

(e) Open and competitive markets, without price controls or monopoly powers conferred by statute;

(f) No trade barriers. If import protection is deemed necessary, tariffs are generally preferable to quantitative controls. Rates of tariff should be as even as possible to minimize distortions;

(g) Open, competitive and lightly regulated capital markets, including an inward investment regime that welcomes foreign capital;

(h) A labour market where there is complete freedom to contract between employer and employee (and freedom to form associations voluntarily);

(i) Most important of all, clear and consistent laws that participants in the economy can be confident will be upheld in the courts. Strong property rights and independent judiciary free of corruption are two vital elements of the machinery that is necessary to support markets.

153. There is no easy recipe for economic success, but the global lessons, whether from the spectacular emergence of East Asia or the radical reform of New Zealand, are the same. More important to success than anything else are the economic fundamentals - stable macroeconomic management, investment in people, open markets and allowing prices to reflect economic scarcity.

154. For most countries, realizing such a template of policies would require a substantial adjustment in how the Government sees itself - from Government as controller to Government as the setter of the framework within which markets can operate, but the lesson from New Zealand and other countries is that such a transition is possible, and that the economic and social benefits abundantly repay any transition costs. All that is required is the political will.
