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The New Zealand economy is now famous in policy circles for its turnaround during the 1980s and 1990s. Starting from a state of semiautarky in the early 1980s, New Zealand now has one of the most vibrant economies in the world. In fifteen years, successive governments reformed the country's institutional environment by injecting high doses of deregulation and opening the economy.

Following these changes, the New Zealand economy climbed the ladder of the Index of Economic Freedom: New Zealand's score increased from 5.9 in 1985 to 8.2 in 2002 (Gwartney and Lawson 2004). Yet its average growth rate in the past decade does not compare to that of the Asian tigers, Singapore and Hong Kong, or that of Ireland, Estonia, and Luxembourg, countries that share some of the best ranks in the index.

In addition to the modest growth in the past decade, the relatively poor growth prospects for the years ahead have fueled the debate about the success of the New Zealand reforms. Some economists think that New Zealand's less than stellar eco-

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nomic performance results from the failure to complete the reform process. Others believe that New Zealand's current situation is the result of too much reform: New Zealand has been a "laboratory" for free-market policies, and it went too far. Some maintain that it is now time to go back to more middle-of-the-road policies, taking into account not only economic efficiency, but also income distribution, the environment, and many other issues left out by the reform process. In this view, better "management" of the economy should help to improve growth prospects. The Labour government espoused this opinion when it was elected in 1999 (Kay 2000). Still others think that owing to New Zealand's cultural heritage, its inhabitants are relatively uninterested in high levels of economic growth.[1] New Zealanders, it is said, do not need much money to be happy because they hold dear some egalitarian ideas that go back to the nineteenth century, reflected today in the romantic search for a peaceful and green New Zealand and perhaps also in the revival of Maori *tikanga*.[2]

It is now becoming clearer that in spite of the modest achievements and low productivity growth, the reforms have been hugely beneficial to the economy.[3] In opposition to its earlier views, the Labour government now recognizes the importance of the reforms, as a 2005 *Budget Policy Statement* shows: "NZ's recent growth performance can be attributed to past structural reforms that began in the mid-1980s, which have resulted in a trend increase in NZ's growth rate since the early 1990s . . . a more flexible economy better able to absorb adverse shocks and take advantage of favourable shocks, and sound macroeconomic policy settings" (qtd. in Kerr 2005c, 1). This support is not wholehearted; the phrase "failed policies of the past" has been used at times to characterize what was done during the reforms of the 1980s and 1990s. However, a consensus is now emerging in regard to what has made the economy more vibrant and prosperous. The reforms have had a very positive impact on the entrepreneurial environment; unemployment is low, and growth is reasonably rapid. Most commentators today recognize this situation.

In the long run, what matters is the quality of the entrepreneurial environment. When the institutional and cultural environment enables individuals to discover and seize profit opportunities, growth occurs (Boettke and Coyne 2003; Sautet 2005). Taking this factor into account, I argue here that

- The reforms have vastly improved the entrepreneurial environment, and, as a result, given the starting point, they have greatly enhanced New Zealand's economic performance.

1. Tyler Cowen entertained this idea on his Web log. Aidan Walsh told me that the same was said about Irish people before the 1990s.

2. Maori *tikanga* is the culture of the Maori people, who are the indigenous people of New Zealand.

3. A recent instance of this debate is John McMillan's 2004 observation that "markets are doing their job" and the lack of high growth must be found elsewhere (in geography, lags in adjustment, and so forth). Kerr (2005c) notes that growth since 1999, though reasonably fast, has not been faster than the average of the 1990s, which shows that the new Labour government policies have not had, as of yet, the impact their supporters claimed they would have.

- To go beyond current levels of economic performance, New Zealanders need to improve the entrepreneurial environment further. New Zealand failed to become a growth miracle because the reforms that were implemented, though good, were not exceptional.

I first describe briefly the context in which New Zealand's reforms took place and then, second, consider the five main reforms that changed the New Zealand economy positively. In the third section, I examine the reasons why the New Zealand economy is failing to perform like that of an Asian tiger. Before concluding, I offer some policy implications.

Background of New Zealand's Reforms

Much has been said about New Zealand's reforms of the 1984–96 period. In the words of David Henderson of the Organization for Economic Cooperation and Development (OECD), the reform period in New Zealand was "one of the most notable episodes of liberalization that history has to offer" (qtd. in Evans et al. 1996, 1856). Let us consider the context in which these reforms took place (for more on the context, see especially Evans et al. 1996).

A Long Time Ago in a Country Far Away

To understand the context of the 1980s, one must go back one hundred years. At the end of the nineteenth century, New Zealand was, along with Germany, one of the first countries in the world to implement comprehensive social legislation. Even before the ravages of World War I created a demand for social assistance in Western countries, New Zealand stood at the forefront of social policies. For example, women obtained the right to vote in 1893. Labor-market reforms were introduced in 1894 in the form of a compulsory arbitration system, and a pension scheme was set in place for the "deserving poor" in 1898. The expectation slowly developed that the state should provide "cradle to the grave" protection against life's hazards.[4] From the late nineteenth century to the 1920s, the country was one of the five richest countries in the world as measured by gross domestic product (GDP) per capita. This wealth came from exports of farm produce to England (thanks to the advent of refrigeration) and from a high productivity in agriculture, which reflected a small population and an abundance of fertile land.

In New Zealand during the 1930s, as in many other countries, a rise of protectionist policies (for example, import licensing in 1938), along with a surge in the welfare state, had a negative impact on economic performance. During World War II,

4. For a general history of New Zealand at the turn of the twentieth century, see King 2003, especially chap. 18. Before the enactment of social legislation, the government had an active role in land acquisition and infrastructure development.

many controls were introduced, and the economic decline so prominent in the 1930s continued. In the post–World War II period, New Zealand's international ranking deteriorated further because the wartime controls were kept in place.

As Evans and his coauthors explain, New Zealand's gross national product (GNP) per capita in 1938 was 92 percent of that in the United States. By 1950, the ratio was 70 percent, and by the 1980s it was 50 percent (1996, 1860). In other words, over a period of almost fifty years, New Zealanders experienced constant relative decline in their standard of living. Whereas Australia's relative income per capita leveled off in the 1970s and the United Kingdom bounced back in the 1980s, New Zealand continued to sink, to around the twentieth rank by the time the reforms started in 1984.

By the 1970s, New Zealand had the most regulated economy in the OECD. Until 1973, when the United Kingdom joined the European Community, it represented the main export market for New Zealand products. Afterward, however, that export market disappeared, and the consequences of the policies of the postwar period surfaced. In the 1970s, New Zealand emerged as a semiautarkic economy, the so-called *Fortress New Zealand*. By the end of that decade, more and more young people were leaving the country to gain work experience abroad. For the first time, a generation of New Zealanders found overseas experience not only necessary but also preferable to the opportunities offered at home.

Besides imposing high tariffs and employing import licenses to control the balance of payments, the New Zealand government adopted many other harmful policies. Revenues from high taxes were used to provide subsidies to many major industries. Agriculture, for example, enjoyed large subsidies and had many producer boards protected by law. The government used the public-employment model of welfare to maintain high wages and employment among the masses by employing people in government-owned enterprises, thus keeping the unemployment rate artificially low. As in many Western countries at the time, inflation was rampant (between early 1970 and late 1984, it averaged almost 12 percent per year), and wage and price controls were (unsuccessfully) employed to limit its effects. The labor market was highly regulated. The exchange rate was fixed and set at levels that eventually were no longer credible, given the loose monetary policy and the weak terms of trade.

As a result of such policies, government spending rose from approximately 22 percent of GDP in 1970 to more than 35 percent by 1983, and government debt rose from approximately 5 percent to more than 30 percent of GDP; it continued to grow to 51 percent by 1992. Although these trends were not exceptional—indeed, they were common to most countries in the Western world—their effects, combined with extensive market regulations in a semiautarkic economy, stifled growth and led to the relative impoverishment of New Zealand's people. Unemployment, negligible in the 1960s, was pushing higher than 4 percent of the labor force by the late 1970s.

"There's Got to Be a Better Way!"

The first attempts to reform the economy were made in the early 1980s. Roger Douglas, an opposition politician who would later become the architect of the first wave of reforms, proposed important economic changes in 1980.[5] The Treasury had been giving advice for a few years on regulatory and tax reforms without much success before Prime Minister Robert Muldoon implemented the first serious change, signing the Closer Economic Relations Treaty with Australia. Moves toward freer trade were in the air, but not until 1984, with the change of government, did deeper and more comprehensive reforms became part of the agenda.

In 1984, New Zealand faced a severe crisis. As the elections neared, market participants lost their trust in the Reserve Bank's capacity to maintain the fixed exchange rate. As a result, money poured out of the system, and a currency crisis followed. The Reserve Bank lost almost all its foreign reserves and had to close its currency-trading window before markets reopened on the Monday following the elections. This event caused a governmental crisis, with the outgoing prime minister refusing to implement the instructions of the newly elected Labour government during the interregnum.

Once in place, the new Labour government, led by Prime Minister David Lange and Finance Minister Roger Douglas, devalued the dollar and started implementing changes in the institutional landscape. Many reforms took place in the 1980s under Douglas's leadership and later on in the early 1990s when Ruth Richardson became finance minister with the election of the National government in 1990. These far-ranging reforms dealt with taxation, government spending and other fiscal issues, financial markets, market regulations (especially industrial policy and labor markets), public-sector structure, and social assistance, among other things. Although not all sectors enjoyed successful reforms (the health sector was extensively but unsuccessfully reformed during the 1990s, for example), some of the reforms became models for the rest of the world.

Five Reforms That Changed the Economy

It is often said that there is no silver bullet for reforming an economy; economic reforms must be undertaken as a package, and rarely is a single policy responsible for an economy's success. These observations certainly apply to New Zealand, where an ensemble of policies brought about the economy's resurrection. Among these policy changes, however, five areas of policy may have done 80 percent of the job: tax reforms, labor-market reforms, trade reforms, monetary-policy reforms (including the establishment of Reserve Bank independence), and fiscal reforms.[6] In this

5. This proposal was published under the title *There's Got to Be a Better Way!* (Douglas 1980).

6. Many other reforms also played an important role. For example, competition law was overhauled and simplified: the new drafted Commerce Act of 1986 entirely replaced the Commerce Act of 1975.

section, I briefly examine the impact of these reforms on the economic (especially entrepreneurial) environment. They ushered in a better tax system, a fluid labor market, more extended markets, a stable money supply, budget surpluses, and a reduced public debt.

The Tax System

In its *Statement of Government Expenditure Reform* in August 1985, the government announced the reduction of the top marginal income tax rate and the implementation of a new value-added tax (goods-and-services tax [GST]) to replace a multitude of indirect taxes. The idea behind the changes was to broaden the tax base—that is, to tax hitherto untaxed income and to reduce marginal tax rates. The reduction in the marginal tax rate would improve efficiency by reducing the deadweight loss of taxation, and the broadening of the base would reduce the incentives to pursue certain activities simply to avoid taxation. The top marginal income tax rate was halved, dropping from 66 percent to 33 percent between 1985 and February 1988. The GST covered almost all sales transactions, excluding exports, at a flat rate originally set at 10 percent, but later increased to 12.5 percent in 1989. Corporate and personal income taxes were integrated by the introduction of an imputation system, which removed the double taxation of income by giving shareholders a tax credit for any tax paid at the corporate level. The system was extended in 2003 to New Zealand shareholders owning shares in Australian companies via a trans-Tasman imputation system.

The tax reforms in New Zealand were characterized by an emphasis on compliance costs—a direct influence of the transaction-costs approach that prevailed in the New Zealand Treasury in the 1980s. The tax system was designed to be a coherent structure that would minimize the deadweight losses and reduce the compliance costs. One of the most conspicuous results of the focus on compliance costs was that most taxpayers no longer filed a tax return. The tax changes improved the business environment. Investment choices became less influenced by tax considerations, and the tax system did not lend itself to lobbying as much as it had in the past.

In 2000, the first Labour government increased the top marginal income tax rate from 33 percent to 39 percent for incomes above NZ$60,000. Doing so disrupted the alignment between the company, trust, and top marginal income tax rates and made taxation a more important variable in people's choices: whereas previously the top personal income tax rate of 33 percent had been aligned with the corporate tax rate and applied also to income from trust, the income tax change broke the alignment and reintroduced the potential for tax arbitrages. Even though a top marginal tax rate of 39 percent is still not very high by international standards, increasing the marginal rate did not improve the tax system, especially in an era of fiscal surplus. According to Davidson, the threshold of the top income tax bracket as a proportion of GDP per capita is 1.21 for New Zealand. It is only 0.50 for Hong Kong, but that jurisdiction has a marginal tax rate of just 17 percent. In Singapore, the threshold income to GDP per capita is 9.53, and the marginal tax rate is 22 percent (all foregoing figures from Davidson 2005).

The tax system creates some problems, especially with regard to the capital-labor boundary and the interface between the welfare system and the income tax schedule. For example, tax credits and the other welfare benefits tied to income that a recipient may receive are abated as income rises. This abatement creates very high effective marginal tax rates, which increase the opportunity cost of improving one's own income situation. In other words, welfare benefits and low-income tax credits inevitably contribute to the creation of poverty traps. Also, the amount of post-tax profits that entrepreneurs can capture affects entrepreneurial activity. The higher the post-tax profits, the more likely that hitherto unknown possibilities to trade will be discovered. The tax system therefore affects entrepreneurial discovery because it influences the pure monetary profit that emerges through exchange (Kirzner 1985a).

Labor-Market Liberalization

Labor markets have long been regulated in New Zealand. Early landmarks include the adoption of compulsory arbitration in 1894 and compulsory union membership in 1936 (see Baird 1996; Evans et al. 1996; Kerr 1999, 2005a; Carroll et al. 2002; Mills and Timmins 2004).

The Employment Contract Act of 1991 was, in Charles Baird's words, "a bold, giant step toward the worthy goal of restoring freedom of contract to New Zealand labor markets" (1996, 1). The act replaced centralized bargaining with decentralized enterprise (or individual) bargaining. It gave employees and employers a choice of individual employment contracts or collective ones, and under it, no special agent needed to represent the parties to the labor contract. In most cases, individuals chose to represent themselves.

The Employment Contract Act, alongside other reforms, had an enormous impact. The unemployment rate fell from 11 percent to less than 4 percent between 1991 and 2004. During this period, the nature of contracts changed dramatically: multiemployer contracts virtually disappeared, and direct contracts between employer and employee became the norm. The labor market became much more fluid.

Labor laws constitute one of the major elements determining the quality of the entrepreneurial environment. To some extent, a business firm is a locus of planning, where entrepreneurs hire the services of factors in order to exploit discovered opportunities.[7] Labor is the primary factor in almost all business organizations. Therefore, the nature of labor laws clearly influences the way entrepreneurs can contract with the owners of resources that are crucial to the capture of profit opportunities. When profit opportunities are discovered, entrepreneurs need to bid away resources already at work in the economy. The process of "efficient allocation" of resources at the heart

7. See Sautet 2000, especially chap. 2 on the notion of the "simple firm."

of neoclassical economic analysis begins with and can exist only within the entrepreneurial discovery process. This process requires the ability to contract as freely as possible for the use of the resources needed to capture the gains that entrepreneurs discover. When labor laws restrict contractual possibilities, they adversely affect entrepreneurial activity by shrinking the population pool entrepreneurs can use.

Trade Liberalization

In the 1970s and the first part of the 1980s, New Zealand had one of the least-open economies among the OECD countries. As Evans and his colleagues put it, "For most categories of goods there was little variety" (1996, 1883). Many import restrictions set in place during World War II lasted until the mid-1980s. Many goods produced or assembled in New Zealand in the 1970s would have been produced elsewhere had free trade been possible. Entrepreneurs were limited in their capacity to differentiate their goods; trade restrictions stifled the exploitation of comparative advantage.

In some ways, the reforms to improve trade conditions started in 1984, when the first Labour government devalued the New Zealand dollar. Capital flows were also partially liberalized during the same year, which increased foreign ownership of New Zealand assets. In 1990, complete free trade of goods with Australia was implemented, and tariffs on goods from all other countries were gradually reduced. In September 1998, the government announced plans to remove most tariffs by July 2001 and all tariffs by 2006—that is, to adopt unilaterally complete free trade with all countries.

Trade liberalization reforms dramatically increased the range of goods and services available in New Zealand, and the impact on consumer welfare was enormous. For example, between 1983 and 1993 the ratio of imports plus exports to GDP rose by 42 percent, dramatically increasing the diversity of goods available to New Zealanders (Evans et al. 1996, 1883). Trade liberalization also increased entrepreneurial activity by extending the market available to entrepreneurs, creating an effect similar to an increase in population size.

Monetary Policy and the Reserve Bank

The Reserve Bank Act of 1989 was another stepping-stone in the reform process. It replaced the 1964 Reserve Bank Act, which had given politicians the freedom to use monetary policy to deal with whatever problems the government thought it had. Monetary policy was one of the most inconsistently used instruments of macroeconomic policy, with multiple targets and lack of accountability (Evans et al. 1996). The Labour government in 1984 took a different approach: monetary policy would no longer be a short-term instrument in the government's hands; it had to become a long-term instrument aimed at creating a stable environment by containing inflation. Not only was inflation in the early 1980s high, but inflation expectations were not in line with inflation outcomes: expectations were higher than actual inflation because the Reserve Bank's credibility was low. Monetary policy under previous governments had not achieved the desired results. Reducing inflation and making monetary policy more credible were the main reasons for the enactment of a new Reserve Bank Act. Moreover, inflation was not to be used any longer to finance the fiscal deficit. Deficits would be financed by the issuance of debt, then eventually reduced and turned into surpluses.

The key elements of the Reserve Bank Act of 1989 were: a clear single target; transparent objective setting; and operational independence and accountability of the Reserve Bank.

The inflation target in the first policy target agreement, reached in 1990, was 0–2 percent inflation (measured in terms of the annual change of the consumer's price index). Subsequent policy target agreements were signed in 1992, 1996, 1997, 1999, and 2002. In 1996, the twelve-month increase in the consumer's price index consistent with price stability was enlarged from 0–2 percent to 0–3 percent. When Governor Alan Bollard took office at the Reserve Bank in 2002, the new target agreement raised the bottom of the inflation target to 1 percent, while retaining the 3 percent upper limit.

Although in 1989 the Reserve Bank's function was identified exclusively as the maintenance of price stability, the bank's objectives have changed slightly over the years. The intent of the 1989 Reserve Bank Act remains, but broader economic goals are now also part of the mission. As Bollard has recently declared,

> Price stability is the Reserve Bank's "primary function," but we also seek to avoid "unnecessary instability in output, interest rates and the exchange rate." The shift to an inflation target "on average over the medium term" allows us to better achieve this. This helps economic growth, which, we all agree, New Zealand needs, by enhancing predictability and confidence and, by that, savings and productive investment. The raising of the bottom of the band brings the overall target more in line with New Zealand's inflation outcomes in recent years and those in other countries. (Reserve Bank of New Zealand 2002)

Since June 1991, inflation as measured by the consumer's price index has averaged 2.1 percent, which is within the target band (Reserve Bank of New Zealand 2005)—a substantial achievement, considering the history of monetary policy in New Zealand and its outcomes before the 1989 act. However, the recent changes to the policy target agreement have given monetary policy broader goals (for example, avoiding unnecessary instability in output), which will not be achieved through monetary policy and which will contribute to the deterioration of the quality of the entrepreneurial environment.[8]

8. As history showed in the 1970s, central-bank policies designed to achieve macroeconomic results are generally not successful. Looser monetary policy achieves only greater inflation and poorer economic performance in the long run.

A stable monetary environment is important to entrepreneurship. Monetary prices convey information about market demands and supplies that is crucial to the discovery of profit opportunities. Monetary calculation can be carried out best if money plays its role well by providing a medium of exchange with reasonably stable purchasing power.[9] The presence of price inflation (induced by bad monetary policy) reduces the effectiveness of money to convey accurate information and thereby worsens the entrepreneurial environment.

Fiscal Policy and Balanced Budgets

Public debt in New Zealand rose from less than 10 percent of GDP in the 1970s to more than 50 percent in 1993. As the Labour government took office in 1984, the fiscal position was becoming more difficult to sustain. In spite of immediate measures, ongoing deficits and large borrowing costs continued to climb into the early 1990s. Part of this debt spiral was the cost of the reforms, but it was also the result of years of bad Keynesian policies. As a consequence of the debt situation, Standard and Poor's and Moody's Investor Services downgraded New Zealand's credit rating for sovereign currency debt: the country lost its "triple A" rating in 1983 and did not recover it until nineteen years later, in 2002.

In 1984, a program of fiscal stabilization was started. In 1989, Parliament adopted the Public Finance Act, and in 1994, Finance Minister Ruth Richardson introduced the Fiscal Responsibility Act. The Public Finance Act replaced an input-focused system for controlling government base spending with an output-focused one. Although this change was controversial at the time, government departments have adapted well to it since then. By further rationalizing government spending decisions, the Public Finance Act helped departments be more responsible with taxpayers' money. For example, whereas under the old system all spending increases were indexed, departments now must prove that nominal spending should be increased because cost increases outweigh productivity gains (nevertheless, many programs remain indexed). At least until the mid-1990s, this act had a positive impact on controlling government spending by constraining increases in nonindexed government spending and thus helped to reduce budget deficits and public debt.

Whereas the Public Finance Act focuses on how departments spend money, the Fiscal Responsibility Act provides rules for the conduct of fiscal policy. Its goal is to improve that policy by establishing five principles of fiscal management and by strengthening reporting requirements. The five principles laid down are:[10]

9. Money's purchasing power can never be completely stable. Still, the price inflation that results from increases in the money supply diminishes the purchasing power of money more than it would diminish because of other changes in the market.

10. See New Zealand Treasury 2005b. The 1994 Fiscal Responsibility Act was replaced by the Public Finance (State Sector Management) Bill in 2003. In this new legislation, "fiscal management" replaces the "fiscal provisions" approach. However, the intent of the bill remains the same, which shows how even with multiple changes of government, the idea of fiscal discipline is now well accepted in New Zealand.

- Increase the transparency of policy intentions and the economic and fiscal consequences of policy;
- Bring a long-term (as well as an annual) focus to budgeting;
- Disclose the aggregate impact of a budget in advance of the detailed annual budget allocations;
- Ensure independent assessment and reporting of fiscal policy; and
- Facilitate parliamentary and public scrutiny of economic and fiscal information and plans.

The Fiscal Responsibility Act contributed to the fiscal stabilization of the 1990s. The increased transparency of the government's short-term and long-term fiscal intentions and the high standards of financial disclosure improved government incentives. However, the change in the electoral system in 1993 and the election of the first coalition government in 1996 led to higher spending per capita.

The New Zealand government ran its first operating surplus (more than $900 million) in the 1993–94 fiscal year. It was the first budget surplus in seventeen years and was dedicated to debt repayment. Since then, the government has run only budget surpluses. Moreover, net public debt in 2004 was down to approximately 10 percent of GDP and was forecast to decline further in the years to come (New Zealand Treasury 2005c).

Although fiscal discipline is now a reality in New Zealand, it is difficult to establish the extent to which the improvement is the result of the Fiscal Responsibility Act because the fiscal position also improved with the betterment of the economy.[11] Although the fiscal situation would have been worse without it, the act has little power over the growth and quality of government spending. In Bryce Wilkinson's words, the "biggest concern . . . is [the act's] failure to do more to impose value-for-money disciplines on new and existing government spending" (2004, 13).

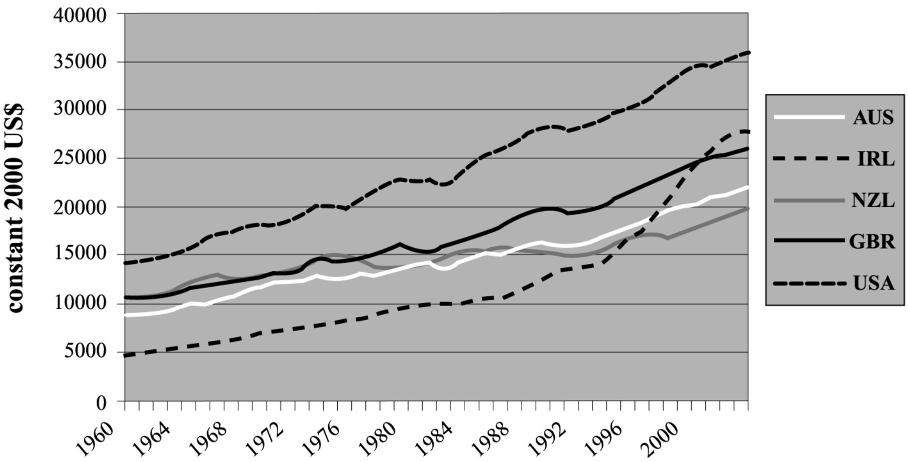
The Missing Link Between Kiwis and Tigers

The Irish economy grew by 8 percent annually between 1995 and 2000 (Lynch 2005). This sterling performance surprised many commentators, including some policymakers who participated in the Irish reform process. According to economist Colin Lynch, no magic recipe explains Ireland's economic success. Rather, it springs from a series of reforms that taken together changed the business environment in a very favorable way. As Benjamin Powell (2003) explains, the massive increase in economic freedom in the past twenty years is the best overall explanation of the Irish miracle.

As figure 1 shows, New Zealand's GDP per capita in 1960 was approximately the same as that of Great Britain and was considerably greater than that of Australia or Ireland (though less than that of the United States). By 2003, New Zealand was

11. See Wilkinson 2004 for an analysis of the impact of the Fiscal Responsibility Act during the 1994–2004 period.

Figure 1
Gross Domestic Product (GDP) per Capita (Constant 2000 U.S. $): Australia, Ireland, New Zealand, Great Britain, and the United States, 1960–2003



last in this group, well behind Great Britain, Australia, Ireland, and the United States. In other words, the reforms have not helped the economy climb back up the OECD rankings of income per capita to the same extent that Ireland's reforms have propelled its economy upward.

Although the reforms have improved New Zealand's rankings in the Index of Economic Freedom, they have only stopped the economy from deteriorating further relative to other OECD countries. The five policy changes discussed earlier have dramatically changed the entrepreneurial environment, and New Zealand has become a reasonably deregulated and competitive market economy, but it has not become a growth dynamo (Wolf 2004).

In contrast to New Zealand's economy, Ireland's economy has experienced a phenomenal recovery (see figure 1). In 1960, Ireland was the poorest country in the group by a big margin (the Irish GDP per capita was less than half that of New Zealand). By 1996, however, after two decades of reforms, Ireland's GDP per capita was higher than that of New Zealand; in 1997, it was higher than that of Australia; and by 2000, it was higher than that of Great Britain. No single factor lies at the root of New Zealand's relatively slow growth, but rather a series of factors that taken together have limited the incentives for entrepreneurs. In the remainder of this section, I examine why the New Zealand economy has not yet become the "tiger of the South Pacific."

The Size of Government

Many commentators on the New Zealand economy do not see the size of government as an explanation of relatively poor economic performance. The New Zealand Treasury (2004) and the Ministry of Economic Development (2005) see the source of sluggish growth in the low investment ratio, not in government spending.

The level of central government spending in New Zealand has not changed much since the early 1980s. What has changed is the efficiency of tax collection and the ways tax revenue is being spent. This fact shows that not only the amount of government spending matters, but also its structure. The enormous restructuring of New Zealand's public sector and the resulting improved quality of its decision-making processes have reduced the government's burden on the economy.

Nevertheless, the proposition that countries with big government do not grow fast has been corroborated empirically.[12] It is true that many OECD countries have big governments, but none of them has grown fast for long periods in this condition.[13]

One reason for this relationship is that large government spending causes more entrepreneurs to respond to government-created price signals, setting in motion what Israel Kirzner calls the "superfluous discovery process." The discoveries are superfluous because they are based on false profit signals created by government activity, which do not reflect individuals' preferences and, as a result, change the economy's patterns of saving and consumption. False profit signals (that is, those profit opportunities created or induced by government activity) lead to unproductive entrepreneurship and poorer economic performance (Kirzner 1986, Sautet 2002, 2005).

Another reason for the relationship is that even with improved government structures, governments are not capable of acting entrepreneurially. Much government activity involves transferring resources through taxation, not creating value. When cost-benefit analysis is used by governments, it is often, though not always, guesswork.[14] Core government spending and government transfers of all kinds do not and cannot rely on the profit-and-loss guide that entrepreneurs use in the discovery process. Because government decision making is not guided by profit and loss, government bureaucrats are not entrepreneurs.

It is true that the New Zealand government owns commercial entities (state-owned enterprises). However, it is not clear what would happen if one of them were

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12. See Gwartney, Holcombe, and Lawson 1998; Bates 2001; Kerr 2002; and Wilkinson 2004, section 3.4. See also Grimes 2003 for the opposite view when applied to the New Zealand case, and see Wilkinson 2004, 35, for a rebuttal of Grimes's view.

13. The proposition is that no OECD country has achieved sustained growth of GDP per capita of 4 percent or more annually with total government outlays at 40 percent of GDP (Wilkinson 2004). New Zealand's total government outlay was 34.1 percent in 2004, Ireland's was 34.3 percent, and Australia's was 35.5 percent (OECD 2005).

14. The use of cost-benefit analysis signals progress in the management of governments. However, in most cases, it does not rely on market prices and is therefore more akin to guesswork than to economic calculation.

to experience losses. The government might bail out the enterprises it owns more readily than it bails out private companies experiencing losses.

Most government spending weakens the general entrepreneurial discovery process because such spending consumes resources that entrepreneurs would have used to create value. It is impossible to elicit high levels of productive entrepreneurship and at the same time to have the government use up a large amount of the economy's resources.

The burden of New Zealand's current levels of government expenditures could be diminished by freezing those expenditures. If held at 2004 levels, government spending would be down to 26.7 percent of GDP by the year 2008–2009 (Wilkinson 2005). Adoption of constitutional constraints on government spending might help achieve such a result.[15] Freezing government spending would force harder choices to be made by revealing the trade-offs associated with the status quo. This revelation might lead, for example, to a reduction in welfare expenditures. Total expenditure on social welfare as a proportion of national income has increased since the beginning of the reform process.[16] The incentives are now great for low-income individuals to receive welfare income instead of working. Government transfers constitute one of the biggest items in the budget. Freezing government expenditures would also force the government to finish privatizing some of its assets (for example, state-owned enterprises). Finally, it would limit public-choice problems: with less money being spent, interest groups have less incentive to dedicate resources to rent seeking.[17]

The 2005 budget included significant additional spending to promote increased opportunities, particularly through education; to enhance security through health spending, additional police staff, a long-term defense-spending plan, and funding for Working for Families and the Rates Rebates scheme; and to support economic growth (New Zealand Treasury 2005a). These large increases in spending help to explain the deteriorating growth forecast for the years up to 2009. Instead of freezing expenditures, the Labour government has chosen to increase them, which will only cause further damage to the entrepreneurial environment.

Taxation

The design principle of the New Zealand tax system—broad-base, low-rate taxation—is desirable insofar as low rates compensate for the broader base. If rates are not low-

15. See Wilkinson 2004, sections 4 and 5, for a discussion of mechanisms to limit government spending; see also section 3.5 for a discussion of the nature of core government spending. Wilkinson concludes that 20 percent of GDP would be enough to finance the core government roles and a safety net.

16. See Kasper 2002 and Brash 2001. Don Brash regards transfer payments as a major burden on the New Zealand economy.

17. A good indicator is the number of government employees (government administration and defense), which went down from fifty-eight thousand in 1990 to forty-two thousand in 2000. It increased again after that and in 2005 stood at fifty-two thousand (*Statistics New Zealand* 2005).

ered enough and the base is expanded, average tax rates remain high. Although the incentive to engage in market activities (vis-à-vis nonmarket activities) has increased because marginal rates have fallen, the base has been broadened, which reduces the scope for untaxed activity. As Davidson puts it, "Unlike the situation in many countries, New Zealand's income tax base is relatively broad and provides limited scope for taxpayers to avoid the top tax rate" (2005, 3). (Individuals can use trusts to shelter income at a lower marginal rate: trusts are taxed at 33 percent, whereas the top rate on individual income is now 39 percent.)

The broadening of the tax base can be illusory. It is not true that consumption can be taxed independently from income. At the end of the day, there is only one tax base: the income realized through exchange. Simultaneous taxation of any other base is double taxation. This fact has been recognized to some extent in New Zealand—for example, by the abolition of death duties. However, the income tax, the GST, and excises all deduct from the same base, even if they offer different opportunities for avoidance.

Designing the tax base opens the door to many problems, such as whether capital gains and imputed rental income in owner-occupied housing should be taxed. Other considerations—such as compliance costs, political feasibility (that is, income distribution), and fluctuations of tax revenues—are often taken into account in the design. Although using monetary income and consumption as the tax base may make sense, doing so creates multiple layers of taxation and therefore increases the tax burden.

The overall impact of the New Zealand tax reforms on the entrepreneurial environment has been positive. Average and marginal tax rates, however, are still high, and this condition affects the entrepreneurial discovery process.[18] Between 1985 and 2002, the total burden of taxation relative to GDP per capita increased by 3.6 percentage points, rising from 31.3 to 34.9 percent. In comparison, the burden of taxation in Ireland declined from 35 percent to 28.4 percent.[19]

The complexity of the effects of taxation in practice can be seen by examining corporate taxation in Ireland. In 1980, the Finance Act introduced manufacturing relief, which established an effective rate of corporate tax of 10 percent. The category *manufacture* was extended in 1987 to include financial services, shipping, films, and other sectors. The regular corporate tax rate in Ireland was 45 percent in 1980 and was increased to 50 percent in 1982. From 1988 onward, it was reduced, finally reaching 12.5 percent in 2003 (Martyn and Reck 2004, 50). In practice, the extent of the manufacturing sector was not always clearly defined. Given the difference between

18. This fact is reflected in the Heritage Foundation 2005 Index of Economic Freedom: New Zealand scores 4 out of 5 (best being 1) in the "fiscal burden of government" category (Miles, Feulner, and O'Grady 2005).

19. See OECD Revenue Statistics 1965–2003 (OECD 2004). However, comparing figures for taxes as a percent of GDP across countries is difficult. Differences in tax systems may not be accounted for in tax revenue figures; for example, social security contributions come from general taxation in New Zealand, but in some other countries they do not. Also, GDP growth can get ahead of the political economy of taxation.

the regular corporate tax rate and the manufacturing corporate tax rate, a large number of tax-arbitrage structures were set in place to reduce the effective tax rates of corporations.

Small open economies depend to a greater extent than do big countries on foreign direct investment. The tax treatment of those foreign investments, in conjunction with other factors, is important to capital markets. Although foreign investment did not increase in Ireland for years, the broader changes in the institutional environment created the momentum for it to grow by taking advantage of the 10 percent tax rate offered to foreign corporations.

The New Zealand government's 2005 budget included a few changes to taxation—in particular, small tax cuts to encourage investment and savings and to assist small businesses. These cuts may be paid for in part by a new carbon charge in the future. Tax thresholds will increase to catch up with inflation. A new work-based savings scheme, KiwiSaver, will also be created. These tax changes will not reduce the overall burden of taxation, however, and therefore are likely to have very little positive impact on entrepreneurial activity.

The Openness of the Economy

Only in the past twenty years has the New Zealand economy begun to open its borders fully to trade. The effects of more open borders take time to surface because entrepreneurs often rely on their knowledge of local market conditions. As the economy opens up, trade with more distant lands becomes possible, but the accumulation of knowledge about foreign-market conditions requires time. Modern information technology reduces that lag time but does not eliminate it.

Time is also needed for foreign-market participants to realize the extent of the changes in a country and the effects of those changes on the quality of the country's products. In the 1950s, Japan and Taiwan were considered places that made cheap, low-quality products. Thirty years later, opinions of their goods had improved because the two countries had become a source of high-quality and high-tech products. Likewise, New Zealand's image as little more than an exporter of lamb and mutton has dramatically changed since the early 1990s. This change will probably continue and accelerate over the next decade or two.

This factor also relates to the issue of size. Although openness can compensate for the small size of New Zealand's economy, New Zealand does not have access to a common market of 300 million people as Ireland does. Foreign tariffs erected against New Zealand products hurt the New Zealand economy, reducing the size of the market available to its producers and damaging the entrepreneurial environment. For example, the United States taxes New Zealand lamb and cheese heavily. Because of the barriers to trade posed by foreign tariffs, New Zealand is not in a situation similar to that of Ireland with regard to market size. In this respect, New Zealand would benefit from joining the free-trade agreement between the United States and

Australia, provided the agreement allowed for free trade in agricultural goods. Doing so would open the door to the North American trade zone, which comprises more than 300 million people.

In the 1950s, some forty thousand people emigrated every year from Ireland.[20] In 2004, the flow was the reverse: more than thirty thousand individuals immigrated to Ireland (Ireland Central Statistics Office 2004). This recent influx is both a consequence and a cause of the economic change. Individuals also decide to stay in the country because they see the better quality of life that can be obtained in Ireland. The net population inflow creates a cumulative process in which more people entering the country expand internal markets and the community of entrepreneurs, thereby enhancing the division of labor and knowledge necessary for effective capital accumulation.

The same process is occurring in New Zealand, where the "brain drain" has stopped: net permanent long-term migration has been positive since the 1990s (except in 1999) and is increasing, although it remains volatile.[21] New Zealand is becoming a better place to live, and net positive long-term migration is one result of that improvement. The virtuous cycle of immigration will help to improve New Zealand's economy by expanding internal markets and the community of entrepreneurs. It has been said that Ireland has benefited from its links to the United States forged by the Irish diaspora. Although New Zealand may not be in a similar situation, New Zealanders have more international connections today than they had twenty years ago. The world in effect has become a smaller place, and people have better knowledge of foreign markets, which helps entrepreneurs to build the bridges they need to distant markets and slowly increases New Zealand's integration with the rest of the world.

Free trade in goods is a substitute for free migration. For a long time, New Zealand allowed people to migrate—free migration with Australia has always been enforced, and many New Zealanders have British passports—but goods could not pass freely. The economic reforms dramatically changed this situation, and today New Zealand embraces free trade more completely than do most OECD countries. In September 2003, the government announced its tariff policy for post-2005. The highest tariff rates, between 17 to 19 percent, will be reduced to 10 percent by July 1, 2009. Tariff rates on all other goods will be reduced to 5 percent by July 2008. Alternative specific tariffs reverted to the apparel ad valorem tariffs on July 1, 2005. It is difficult to know what the overall effect of such measures will be on the entrepreneurial environment, although they should be positive. For now, however, the path to complete free trade remains obstructed (especially by foreign tariffs imposed on New Zealand products), which greatly reduces entrepreneurial activity, job creation, and economic performance.

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20. Net annual emigration from Ireland averaged thirty-nine thousand per year from 1951 to 1956 and forty-two thousand per year from 1956 to 1961 (Redmond 2000, 14).

21. See *Statistics New Zealand* (2005) key demographic indicators and Glass 2004.

The Regulatory Framework

The overall regulatory environment in New Zealand is of very good quality and has dramatically improved since the mid-1980s. The World Bank Doing Business Indicator (World Bank 2005) ranked New Zealand number one in 2005. The enforcement of property rights is excellent, the level of corruption is negligible, and the major costs associated with the conduct of business affairs are relatively small.[22] Although the overall regulatory environment and the general institutional framework are solid, some issues still need to be considered.

First, although the labor market has become much more fluid following enactment of the Employment Contract Act in 1991, the act contained some restrictions on contractual arrangements, which have worsened over time. The limits to freedom of contract are:

- No contract that requires any person to be a member, not to be a member, or to leave a union is permitted.
- No one can contract out of a provision of the act.
- The act's mandatory personal-grievances provisions are especially rigid in the case of unjustifiable dismissals: employment at will was abolished in New Zealand in 1991, although it accounted for a significant portion of all labor contracts until then.[23]
- Disputes with regard to employment contracts must be settled in the Employment Court, a special court for labor issues. Over the years, this court has partially undermined the intentions of the framers of the act by emphasizing procedural correctness and "fairness" in dismissals.

The Labour government elected in 1999 repealed the Employment Contract Act and replaced it with the Employment Relations Act, which came into effect in October 2000. The Employment Relations Act introduced or reintroduced "good faith" bargaining, the promotion of mediation over litigation, and union monopoly on collective bargaining. By and large, it promotes collective bargaining by various means, such as the requirement that employers give union representatives information and workplace access. Yet it retains the idea of freedom of contract.

The Labour government in its second term made more changes in the Employment Relations Act that came into effect in December 2004. Taken together, these modifications further restrict the possibility for entrepreneurs to contract out for labor services. They offer special privileges to employees by facilitating collective bargaining, unionization, and multiemployer collective agreements.[24]

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22. World Bank Doing Business Indicator (World Bank 2005), the Corruption Perceptions Index (Transparency International 2004), and KPMG 2003; see also Djankov et al. 2002.

23. Employment at will is the employer's ability to hire and to dismiss without showing a cause, along with the employee's ability to quit without justifying his action (unless otherwise stipulated in the contract).

24. Many other regulations affect labor contracts, touching on health and safety requirements, discrimination (regulated by the Human Rights Act), minimum wage, legally mandated holidays, the state monopoly in accident insurance (opened to competition in 1998, then renationalized in 2000), and taxpayer-funded paid parental leave.

So far these changes have not had negative impacts on employment. Unemployment in New Zealand stood at 3.6 percent in December 2004, and labor-market participation was more than 75 percent. New Zealand has a rate of job creation and destruction twice as high as that of most European countries. By and large, the labor market is fluid and working well.

However, labor laws have become more rigid since the new Labour government took office in 1999. The implementation of the Employment Relations Act in 2000 and its changes in 2004 have worsened the entrepreneurial environment, as reflected in the Economic Freedom of the World Index, where in 2004 New Zealand received a score of only 5.9 for labor regulation, relative to 10, the best possible score (Gwartney and Lawson 2004).

New Zealand's regulation of utilities, especially gas and electricity, is ill-conceived and excessive. The government is now going back to a more regulated environment, adopting forms of utility regulation that other OECD countries have used, such as establishing dedicated policy watchdogs, a role the Commerce Commission is now undertaking. The utilities reform of the 1990s was based on the idea that utilities were similar to any other commodity producers and thus could be left to operate in the market. However, the dominant views about monopoly and market power have influenced the reform process in ways that never permitted the market to operate fully. The privatization and deregulation of utilities in New Zealand is incomplete and is now going backward, with the Labour government reintroducing the visible hand of regulation.

The government has resumed ownership of commercial enterprises, such as Kiwibank, Air New Zealand, and the railway system. Although these enterprises face commercial incentives, their cost of capital is artificially reduced, which may weaken their performance. Taxpayers' money would be better invested by the taxpayers themselves. Instead, state-owned enterprises that should be privatized immediately still await privatization.

Other smaller but still important regulations have changed in a way that is unfriendly to the entrepreneurial environment. Examples include takeover regulations, the Commerce Act, industrial policy (for example, the government's Growth and Innovation Framework), and the Kyoto Accords.

The devil is in the details. Although the major costs of doing business are still relatively small, the trend is now toward more regulation.[25] New Zealand should strive to keep its regulation light-handed in accordance with the mantra of the 1980s reforms. Any other approach contributes to the growth of government and thus is detrimental to the entrepreneurial environment.[26]

25. See Tyler Cowen's Web log of July 8, 2004: "Is New Zealand Backsliding?"

26. See Wilkinson 2001, especially chap. 8, on ways of constraining government regulation.

Unfinished Business

A recent survey shows New Zealanders' attitudes toward business and the economy to be reasonably good.[27] New Zealanders are interested in a good quality of life, have ambition and motivation in their personal lives, and favor business and economic growth. Like many other people, they are interested in bettering their lives. After years of reform, they also understand that to create wealth one needs to work and have a cultural attitude that by and large favors the market system over government dirigisme. This cultural attitude is important to the future of the economy because it may help people to resist the temptation of more intervention if economic conditions deteriorate.

Nevertheless, the reform process has stalled in the past ten years, and to a large extent New Zealand has lost its bearings: the consistent reform of the 1984–95 period has given way to a stop-start, zigzag reform effort (Kasper 2002). Among other things, the Labour government sees more active policies as a way to improve economic performance (Clark 2002). The founding of the economic development agency called New Zealand Trade and Enterprise manifests this view. Some in power still see picking winners and conducting an active industrial policy, such as clustering and awarding grants to businesses, as a route to prosperity.

Governments around the world have used such policies with little success. The example of Ireland is often cited as a case in which grants from European Union (EU) structural funds have made a difference. In reality, however, Ireland's economic growth occurred in spite of EU transfers. Net EU receipts and Irish growth rates have moved in opposite directions, and the high growth of the late 1990s occurred as EU transfers were phased out.[28] EU transfers have not contributed to improvement of the entrepreneurial environment in Ireland, which is what ultimately matters. Similarly, New Zealand's recent active industrial policy has not contributed to improvement of the entrepreneurial environment. Quite the opposite: it has contributed to the deterioration of that environment by creating rents that entrepreneurs seek and by disturbing market signals.

Another issue emerging since the mid-1990s is the impact of the electoral system. The Electoral Act of 1993 introduced proportionality—called mixed-member proportionality (MMP)—in the New Zealand electoral system, replacing the first-past-the-post (FPP) system.[29] The first election under MMP was held in October 1996. Since then, every government has been formed as a coalition of various parties. No electoral sys-

27. See New Zealand Growth and Innovation Advisory Board 2004, a government-sponsored report, as well as Kerr 2005b.

28. See Powell 2003. See also Powell 2004 for an analysis of the role of industrial policy among the East Asian tigers, and Desrochers and Sautet 2004 for an analysis of clustering policies.

29. Under the FPP system, each member of Parliament is elected because he gains more votes than any other single candidate in his particular electorate. This system was replaced because it tends to foster a two-party system and delivers majority governments, thus ignoring third parties even when they achieve a significant level of support.

tem is perfect, to be sure, yet MMP, by fostering coalition governments, can stifle the capacity for reform and can thus increase public spending. The reforms of the 1984–95 period were possible in part because of the FPP system and the unicameral parliamentary system. Moreover, various studies have shown that public spending is higher under proportional representation than under the FPP system.[30] The existence of coalition governments helps to explain the modest growth New Zealand has experienced since 1996, and it is likely to stifle more reforms in the future.

The Labour government has made growth a top priority, but this commitment has not contributed to improved economic performance. Governments cannot engineer growth; they can only create the context in which entrepreneurial activity takes place. By improving the institutional context, government indirectly steers entrepreneurship toward productive and socially beneficial activities (Boettke and Coyne 2003; Sautet 2005).

The New Zealand government should now focus on four major policies to improve entrepreneurial incentives:

1. Reduce the size of government by freezing its spending. Although the structure and quality of government spending have improved, the magnitude of that spending relative to GDP has remained almost unchanged since the period preceding the reforms.[31]
2. Reduce the overall burden of taxation, especially marginal tax rates. Taxation affects entrepreneurial incentives by reducing the size of profit opportunities.
3. Continue opening the economy because entrepreneurship, leading to the division of labor and specialization, is enhanced by expanding markets.
4. Continue improving the regulatory environment because in some cases it is becoming worse.

These four types of measures would further improve the entrepreneurial environment, and over time such improvement will raise the prospects for economic growth.

Conclusion

Modest growth in New Zealand is not the result of an overdose of reforms or bad cultural attitudes. Much progress has been made since the 1980s, but more remains to be done if Kiwis are to become tigers. In short, the reform process has not been completed, and more reforms need to be implemented. As Martin Wolf put it in the *Financial Times* in November 2004, “It is simply wrong to describe [the] reforms

30. On the impact of electoral rules on fiscal policy, see Persson and Tabellini 2004.

31. Moreover, the quality of many policies, especially in health and education, has stagnated in the past ten years. A great deal of money has been spent to little effect.

as delivering a *laissez-faire* paradise. The end point is, rather, a reasonably deregulated, competitive market economy, with prudent fiscal and monetary policies and a better-run government." A "reasonably deregulated, competitive market economy," however, is not enough to generate a high rate of growth in income per capita. The way to better economic performance is only through creating a better entrepreneurial environment. Only by guaranteeing the free emergence, discovery, and exploitation of profit opportunities can countries improve their growth prospects over time.

The reforms have delivered substantial results, considering the point of departure, but New Zealand has not become a growth dynamo like Ireland because the reforms implemented did not go beyond OECD standard practice. To become tigers, Kiwis must adopt more radical reforms. Unfortunately, the Labour government in its 2005 budget (and in its new incarnation after the September 2005 election) shows little inclination toward improving the institutional context in which entrepreneurial activity takes place. Rather, it prefers to continue to increase the size of government spending, tinkering at the margin with the rules of the game.

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