Bill Frezza

New Zealand's Far-Reaching Reforms

A Case Study on How to Save Democracy from Itself

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The Accelerator for Freedom

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Foreword

This case study is part of the Antigua Forum, a project of Universidad Francisco Marroquín (UFM). The project has two core components. The first is an annual gathering of experienced and current political reformers, entrepreneurs with an interest in replacing inefficient institutions, representatives of foundations and others who invest in reforms and related ventures, and experts in areas such as political communications and strategy. Here, critical questions are discussed and lessons drawn from past successes and failures, then critically applied to current reform efforts and ventures to raise their probability of success.

The second component of the Antigua Forum is a set of complementary resources designed to aid political reformers, entrepreneurs, and others as they study particular experiences and learn from and work with their peers. The case study is one of these resources. It is structured to dig deep into the experience in a specific country at a specific moment and to outline the process followed, obstacles overcome, key decisions made, and lessons learned.

This case study is about New Zealand. A little over two decades ago, this country's economy was in shambles. Inflation ran rampant, economic growth fell flat, and soaring public debt set new records. Today, New Zealand outscores almost every other country in the world, including the United States, in terms of overall prosperity, personal freedom, and good governance. The experience offers lessons for democracies everywhere that face fiscal, monetary policy, and ultimately political crises. This is the story of how it happened.

Wayne Leighton
Executive director and CEO
The Antigua Forum

Preface

Every election is a sort of
advance auction sale of stolen goods.

H. L. Mencken

All majoritarian democracies face the same structural problem. Past politicians won favor with yesterday's voters through a promise of generous entitlements. Tomorrow's taxpayers must pay the bill in order to keep future recipients from revolting. This fundamental flaw in unfunded liability management can be papered over through dishonest accounting, profligate borrowing, and reckless money printing only as long as a country's economy and population keep growing. Once economic and demographic growth stop, or even slow, an ever-larger number of entitlement recipients have to rely on the financial support of an ever-narrower group of productive taxpayers. At that point, democratic governments risk becoming unstable.

Politicians traditionally respond to threats of fiscal catastrophe with a mix of denial, demagoguery, marginal adjustments, and budget gimmicks designed to push the problem beyond the next election. While this proverbial "kicking the can down the road" approach often provides temporary relief, it only makes the ultimate crisis worse. In this case study we hope to answer two questions: **When the day of reckoning finally arrives and a body politic must face the truth about what it has done to itself, where can people turn to find a proven model capable of putting government finances onto a new and sustainable trajectory? And how can voters best identify and support leaders who can put such a model into practice?**

We believe the answer to these questions can be found by studying New Zealand.

Two decades ago, New Zealand went through a dramatic transformation, from a basket case welfare state saddled with crushing public debt, rampant inflation, and a closed and moribund economy, to what is today widely regarded as one of the freest and most prosperous countries in the world. This is the story of how that happened.

Prosperity Index

The Legatum Prosperity Index is an annual ranking of 142 countries that looks at a combined estimate of wealth and well-being. Many such rankings exist that evaluate both objective and subjective parameters. While several should be examined to get a broad picture, comparisons of a given index across countries at a given time and of a given country across time are indicative of progress or retrogression.

The overall Prosperity Index combines eight equally weighted subindices, which can be examined separately: Economy, Entrepreneurship and Opportunity, Governance, Education, Health, Safety and Security, Personal Freedom, and Social Capital.

A quick comparison of New Zealand's 2014 ranking with that of the United States is instructive:

New Zealand	**United States**
Overall rank: 3rd out of 142	Overall rank: 10th out of 142
Governance: 2nd out of 142	Governance: 12th out of 142
Personal Freedom: 1st out of 142	Personal Freedom: 21st out of 142
GDP per capita: US$41,556*	GDP per capita: US$53,143*
Avg. life satisfaction 7.2 out of 10	Avg. life satisfaction 7 out of 10

> Similar data and results can be found in the World Justice Project Rule of Law Index, the World Economic Forum Global Competiveness Report, and the Fraser Institute Economic Freedom of the World Report.
>
> * World Bank data

The journey begins in 1981 when, faced with twin political and economic crises, a window of opportunity opened for dramatic change. Two individuals stand out in the struggle for reform that dominated New Zealand politics for the next dozen years: Roger Douglas and Ruth Richardson. Both were scions of political families with deep roots in New Zealand. Both were extraordinarily young when they began their respective political careers. And although they represented opposing parties, the two ended up making common cause in a fight against their own party leaders, delivering lasting reforms that reverberate to this day. Roger and Ruth's story, and the story of New Zealand's transformation into what may be the most responsible and well-run democratic government in the world, provides a powerful example for the transformation of other troubled democracies.

Of course, for any democracy to achieve a similar transformation, public support, political will, and wise leadership will be required. Whether, when, and where these things might come from is a tremendously complicated question. However, they are unlikely to come from the incumbent politicians that were the source of the problems. Recent experience during the 2007–2008 global financial crisis has not been encouraging. If democracy is to be saved from its own excesses, it would behoove opinion leaders, economists, journalists, and politicians to study the example set by New Zealand.

Roger Douglas Capsule Bio

Photo credit Wikipedia

Roger Douglas was born on December 5, 1937 into a family whose political history begins with his grandfather William Anderton, an English immigrant to New Zealand who became a Labour Party MP just before the Second World War. Roger's father, Norman Douglas, was also a Labour MP, his time in office briefly overlapping with his son's. Roger received a public education, was a gifted athlete and mathematician, and earned a degree in accounting from University of Auckland.

Roger won his first election to Parliament in 1969. Although he began his political career as a staunch supporter of protectionism, Keynesian economics, and the welfare state—earning him a spot as the youngest cabinet minister in fifty years—by the time our story begins his thinking had shifted dramatically. Roger served as a Labour MP until 1990, when he left to found ACT New Zealand, a new political party dedicated to free-market principles.

Ruth Richardson Capsule Bio

Photo credit Antigua Forum

Ruth Richardson was born on December 13, 1950 into a family whose political history goes back to her great-grandfather

George Pearce, who served in New Zealand's Parliament in the early part of the last century. After receiving a Catholic school education, Ruth's attraction to politics led her to study law at University of Canterbury, where she graduated with honors.

Ruth committed her first political faux pas at the age of twenty-five when she challenged a sitting MP from her own National Party—Sir Roy Jack, speaker and lifelong friend of her family—for the nomination from her district, earning her the enmity of party elders. Unsuccessful in her first two attempts at elected office, she won a seat in Parliament in 1981, making her one of the youngest women in New Zealand to ever serve in that role. She immediately set out to make her prime minister's life miserable with her staunch support of free markets, a role she continued even in opposition through her support of the rival Labour Party's finance minister Roger Douglas.

Ruth retired from politics in 1994, after serving thirteen years as an MP, after which she continued her reform advocacy working with ACT New Zealand.

The Last Gasp of Socialist Rule

New Zealand is a bucolic island country of some four and half million people about as far as you can get from the center of Western Civilization. It slowly evolved from a British colony into a modern nation ruled by a self-governing parliamentary democracy comfortably nestled in the bosom of the British Empire and then the British Commonwealth. The first country in the world to grant women the right to vote, New Zealand comported itself with distinction in the great struggles of the twentieth century, with two hundred thousand of its citizens serving under arms to help the Allies defeat the Axis powers in World War II.

New Zealand's Parliamentary and Party Structure

New Zealand is a unicameral, Westminster-style parliamentary democracy. The queen of New Zealand is the titular head of state, a role currently filled by Queen Elizabeth II of the United Kingdom. Real power is vested in the House of Representatives, a 120-member body that is constrained not by a written constitution, rather by an uncodified set of conventions, acts, treaties, court decisions, and a legislated Bill of Rights.

Politically, New Zealand operates under a multiparty system using a first-past-the-post electoral scheme in which a plurality is sufficient to win election, with no runoffs. While seven parties currently have representatives in Parliament, in practice the National Party and the Labour Party dominate the political landscape, and have done so for some time. The party, or a coalition of parties, that controls a majority forms a government under a presiding prime minister, who

> then appoints other MPs to serve as cabinet ministers. Together they perform the executive function. An independent judiciary serves as a check on the legislature and executive. After Roger and Ruth's time in office, a mixed-member proportional representation scheme was introduced, diminishing the power of the ruling party.

Then as now, New Zealand's economy was centered on agriculture, its major exports being meat and dairy products and, to a lesser extent in recent times, wool. Historically, the majority of the country's trade was with the United Kingdom, that is until it joined the European Economic Community (forerunner to the EU) in 1973. This change required the UK government to abandon its tariff structures and mercantilist trade relations, dealing New Zealand's economy a terrible economic shock. Much like Finland after the Soviet Union collapsed, New Zealand was cut loose to fend for itself.

The political response was disastrous. As Ruth Richardson puts it, "the government tried everything that didn't work." Increased protectionism, an expansion of entitlement benefits, wage and price controls, central economic planning, and Keynesian stimulus in the form of extensive deficit spending and the printing of money by the central bank all contributed to driving the country toward bankruptcy.

Robert Muldoon, prime minster during those years of decline, came to power in a landslide election in 1975 leading the National Party government. Critics described his campaign platform as a "denial of economic reality accompanied by bribery of the voters." His actions once in office confirmed that assessment. Roger Douglas describes him as "the kind of politician who lived in the moment surrounding himself with people who say yes." His biographers were even less kind.

While the standard of living in New Zealand was higher than in both Australia and Western Europe during the 1950s and 1960s, per-capita income dropped to the lowest among all developed nations under Muldoon's leadership. Attempts to wean the country from imported oil during the "energy crisis" of the late 1970s by switching the nation's automobile and truck fleet to synthetic fuels manufactured from local natural gas were a disaster. This was revealed when the price of oil cratered after the United States deregulated the energy sector and new supplies flooded the market. The welfare rolls swelled and the ranks of the unemployed grew.

New Zealand Economic Statistics

GDP growth

Year	1974	75	76	77	78	79	80	81	82	83
	6.8	-1.1	3	-5	-0.6	0.8	2.0	3.6	-0.8	3.7

Unemployment

Year	1974	75	76	77	78	79	80	81	82	83
Thous.	0.7	3.1	4.9	4.1	19.8	24.9	28.8	46.7	47	76
%	0.08	0.35	0.44	0.61	1.84	1.95	2.27	3.69	3.5	5.6

Inflation

Year	1974	75	76	77	78	79	80	81	82	83
COI, %	11.2	14.6	17	14.4	11.9	13.8	17.2	15.4	16.1	7.3

Balance of payments deficit

Year	1974	75	76	77	78	79	80	81	82	83
$m	-1129	-1400	-750	-847	-492	-683	-925	-1166	-1623	1184

Budget deficit

Year	1974	75	76	77	78	79	80	81	82	83
$m	-242	-390	-1002	-506	-694	-1446	-1027	-1525	1818	-2158

By the election of 1981, the National Party government lost the overall popular vote but was able to hang on to its parliamentary majority by one seat thanks to the vagaries of population distribution. That seat was won by Ruth Richardson, all of age thirty, elected to her first public office from a district on the outskirts of Christchurch. It wasn't long after this free-market firebrand arrived to sit on the front row of Muldoon's caucus that all hell broke loose.

"What have you come to Parliament to do, girlie?" Ruth recalls Muldoon asking. "I've come to defeat inflation," which was running at about 15 percent at the time. Muldoon said, "No, no, no, what have you really come to do?" Ruth repeated, "I've come to defeat inflation." She then proceeded to set off shock waves when she demanded to see the country's books.

At that time, the New Zealand central bank had virtually no independence (a shortcoming that would be fixed by legislation to come). The prime minister also served as the finance minister. This made it standard operating procedure for the party in power to crank up monetary policy prior to each election, leaving the hangover for later. It was bad enough that the government's financial accounts were kept on a cash rather than a GAAP basis, encouraging all sorts of chicanery (a common problem across most democracies). Worse, the government's key financial records were closed and not available to the public.

Muldoon insisted that not even Ruth, a member of his own party, could be permitted to examine the Treasury briefing documents that contained a record of the government's income, expenditures, assets, and liabilities. Ruth refused to take no for an answer. "If you want my vote, show me the books, otherwise your government goes down."

The caucus was horrified. Nobody had ever talked to a prime minister like that, least of all a female freshman member barely out of her twenties. Ruth persisted and was eventually marched up to the prime minister's office where she could examine the books, though she was not allowed to make copies. She sat there for two days taking copious notes documenting the deplorable state of the nation's finances.

The donnybrook was on, in an environment that can only be characterized as a period of political deviancy for both parties. The National Party, traditionally pro-market, in favor of sound money, and fiscally conservative, had been governing like unabashed socialists under Muldoon. The Labour Party, traditionally supporters of the welfare state, tax-and-spend fiscal policy, and loose monetary policy, saw their opportunity to return to power as economic reformers.

The remainder of Muldoon's final three-year term was characterized by intense infighting. When Muldoon proposed to introduce wage and price controls to "control inflation" in 1982, Ruth "crossed the floor" voting against the proposal, which in Westminster systems is regarded as political suicide. (Ruth went on to serve four more terms.) Despite her gesture of defiance and the National Party's slim majority, the bill passed when three members of the Labour Party were induced to lend their support.

Treasury and Reserve Bank officials, horrified by the prospects of collapse, consulted with a senior Labour Party opposition leader named Roger Douglas to help frame a platform of reforms based on the best international thinking. Reaganomics was in full swing at the time, with US Federal Reserve chairman Paul Volcker breaking the back of inflation and Ronald Reagan crushing the militant air traffic controllers strike. Monetary and regulatory reform kicked off a brief and sharp recession that cleared much of the malinvestment out of the economy, after which the US economy began roaring back.

The parliamentary elections of 1984 were a disaster for the National Party. The people had had enough, and the Labour Party swept into power on a platform of reform. Despite her party's loss, Ruth Richardson handily won reelection in her district. Now in the opposition, she was prepared to egg on the new government in its efforts to save New Zealand's failing economy.

Rogernomics

In 1984 David Lange of the Labour Party became the youngest prime minister New Zealand had elected in the twentieth century. But the star of his cabinet was the experienced and well-respected Minister of Finance Roger Douglas. A member of Parliament since 1969, Roger was still smarting from Labour's epic defeat in 1975. Like many of his generation, Roger was raised as a tax-and-spend Keynesian within the bosom of a staunch trade union family. However, his training as an accountant with a commercial background, along with the time he served on the public expenditure and commerce committees in his early years as an MP, helped form his views on fiscal responsibility, which he documented in his 1980 book *There's Got to Be a Better Way*. Following the lead of Ronald Reagan and Margaret Thatcher, he used the public's discontent and the growing economic crisis to rally his party into supporting a series of radical restructurings that became known as Rogernomics.

It's hard to understate the impact that this one man had on twisting arms to get his party to support policies previously considered anathema. Thanks to his earlier work with Treasury and Reserve Bank officials and the Labour Party's campaign pledge to open the government books (which elevated Ruth's impertinent demand to national policy), Roger was able to publish the Treasury briefing documents. A move to honest and open accounting was pivotal; one of the key takeaways in what became the miracle of New Zealand.

The sea of red ink convinced the public that dramatic action was required, particularly with the country deep in the throes of a currency crisis. Thanks to all the money printing by the previous government, with inflation spiking as high as 18 percent, and the fixed exchange rate regime under which the New Zealand dollar (the kiwi) operated, an immediate devaluation was called for. Such a move, making New Zealand goods more competitive in world markets, made it politically easier to slash the government subsidies that were required to keep export businesses afloat.

Muldoon—a lame duck in caretaker mode while the new government was being formed—refused. This led to a revolt in his National Party organized by Ruth and others, all of which played out on television with the incoming prime minister denouncing his predecessor as the country held its breath. Muldoon was ultimately voted down by his own party, allowing the incoming government to impose an immediate 20 percent devaluation. As the shock treatment coursed through the economy, Ruth was elevated to the front bench of the opposition, one of only two women in the whole party. As she colorfully described it, "I stuck out like dog's balls."

Ruth took the education spokesmanship to work on school choice and education vouchers, biding her time until the day her party returned to power. Ruth's work on education reform ultimately became a Labour government initiative called Tomorrow's Schools, which in effect made every school in the country a charter school overnight. Each school became a separate entity directly answerable to the parents of the students who attended, because parents were given the exclusive right to elect the board of trustees that governed the school. Education boards, school boards, and other bodies were terminated and parents were given the right to choose which school their child attended. What was politically interesting during this reform period was that good ideas developed by a political opponent were picked up by governments and implemented without embarrassment.

Philosophical deviancy continued as the new Labour government introduced pro-market reforms and the National Party opposed. For three years, Roger had a free run to introduce a series of reforms that brought the economy back to life. (Much of this did not require legislation.) Agricultural subsidies were terminated. Protectionism was vastly reduced. Capital controls were removed. Marginal income tax rates were dramatically cut and the tax base was widened through the introduction of a comprehensive consumption tax. Capital gains taxes and estate taxes were eliminated. Foreign exchange controls were removed and the kiwi was allowed to float. Roger introduced so many dramatic changes at once that the opposition had too many moving targets to hit them all, an important factor that propelled the program forward. Even Roger's own Labour Party had a hard time digesting all the changes, particularly given the divergence from its traditional leftist policies. But the people wanted action, and Roger delivered.

Though technically in opposition, Ruth cheered. But the rapid rate of reform raised the question, what would make them stick? Ruth began thinking about ways to institutionalize reforms that would make it harder for future parliaments to backslide, another important element in the program.

With the 1987 elections coming up, Ruth's National Party leadership made the fatal miscalculation that the population would rebel against Rogernomics. Roger relentlessly pushed more radical reforms, such as the replacement of the graduated income tax with a flat tax, even as his prime minister David Lange urged restraint. Fissures began to appear in the Labour Party as the trade union movement got many of its nominees into Labour seats. These fissures were papered over by an electoral victory even larger than Labour's triumph in 1984 (this shift in the caucus eventually lead to the demise of Roger Douglas and the Lange government as Labour reverted to type). As the National Party licked its wounds, Ruth moved up to opposition spokesman on finance. The opponents of reform were sacked.

As Ruth described it, for the Labour Party, "that's when the rot set in." Never a true believer in Rogernomics, David Lange, the reelected Labour prime minister, reshuffled his cabinet to Roger Douglas's detriment. This did not sit well with Roger, whose policies were generally credited as the reason that Labour won the election. As Roger describes David Lange's position, "You've had the pain, now we're going to enjoy the fruit." Roger knew that much work remained to be done and the two set to publishing dueling white papers. Things came to a head when a bill Roger got passed establishing a simple flat tax regime (23 percent on income from all sources, no deductions) was torpedoed while Roger was out of the country attending the Davos Conference. With David Lange driving his party back to type, both parties were now in turmoil.

During and despite this period of political turmoil—though some might argue because of it—New Zealand enacted its most lasting reforms when advocates for efficient government, free markets, free trade, sound money, and prudent fiscal policy came together from both parties to pass the State-Owned Enterprise Act of 1986, the State Sector Act of 1988, the Public Finance Act of 1989, and the Reserve Bank Act of 1989. These forever changed the way New Zealand's government did business, and were Roger Douglas's lasting legacy.

The Legislative Reforms

The State-Owned Enterprise Act, State Sector Act, the Reserve Bank Act, and the Public Finance Act, together with the later additions of the Employment Contracts Act and the Fiscal Responsibility Act passed under Ruth Richardson's leadership, transformed New Zealand into the one of the best-run governments in the world, its economy into one of the strongest, and its people into one of the most prosperous. These are the pieces of legislation that merit study by activists, statesmen, and politicians looking to rescue their democracies from the ravages that nearly destroyed New Zealand. In this section and the subsequent section, we briefly examine each in turn.

The Stated-Owned Enterprise Act of 1986

The State-Owned Enterprise Act was designed to accomplish three major goals. The first was to corporatize former government departments and agencies to get them running more efficiently, such as the national airline (Air New Zealand), the national railroad (KiwiRail), the national television network (Broadcast Communications Ltd., now Kordia), the Telecom monopoly (now Spark New Zealand), the Post Office, and various electrical power generation utilities, banks, insurance companies, forestry services, and shipping companies. The second was to introduce competition. The third was to prepare many of them, though not all, for privatization.

The overarching goal was profitability; that is, rather than serving as a base for unaccountable civil service sinecures that drained resources from the public fisc while providing indifferent services to the public, each organization was expected to stand on its own and to satisfy the needs of its customers without requiring perpetual subsidies. Most importantly, subsequent to the passage of the act, competition was allowed into many sectors that were formerly government monopolies.

Meanwhile, an independent management would be responsible—and would be held accountable—for running the business. These new entities were required by law to be profitable, to pay taxes at the same rate as private corporations, and to pay dividends to the government at the discretion of the responsible minister. The same law forbade interference in day-to-day management of the enterprise by the government. As a result, activities that previously were a fiscal cost to the government now became net revenue contributors to the national budget. The founder shares and equity bonds held by the government were constructed to be easily transferable to the private market should the company become privatized. And a lengthy set of accountability requirements were built into the statute that allowed the company to be monitored in a manner that would be transparent to the public, including semiannual financial reports similar to the reports required of any public corporation. Annual audits were required.

The freeing of so many markets from government control, and the introduction of both the profit motive and competition, laid the groundwork for all the other reforms to come. For without an economy capable of producing the surplus required for growth, the other reforms may well have stalled.

Formerly State-Owned Enterprises That Were Privatized

- Telecom Corporation of New Zealand Limited – copper network later unbundled between 2006–2008
- State Insurance Office
- Health Computing Service
- Contact Energy – sold to cornerstone shareholder and sharemarket float in 1999

- DFC New Zealand Limited – went bankrupt in 1989 and later liquidated
- Post Office Bank Limited (Postbank) – sold to ANZ
- Shipping Corporation of New Zealand – sold to P&O New Zealand Steel Limited – purchased by BHP
- Air New Zealand Limited – government later bought a controlling share in the company in 2001
- Rural Banking and Finance Corporation – purchased by the National Bank of New Zealand
- Government Printing Office – now GP Print
- National Film Unit – purchased by Peter Jackson and renamed Park Road Post
- Tourist Hotel Corporation of New Zealand Limited
- Export Guarantee Office
- Government Supply Brokerage Corporation (NZ) Limited
- Bank of New Zealand (BNZ)
- GCS Limited – formerly Government Computing Services, purchased by EDS New Zealand
- Tranz Rail (the rail operations of the Railways Corporation) – later renationalized as KiwiRail
- Terralink International
- Radio New Zealand (Commercial Stations) – sold to Clear Channel to form the Radio Network, non-commercial stations Radio New Zealand National and Concert remain
- Vehicle Testing New Zealand – sold in 1999 to the Motor Trade Association
- Numerous national forests, irrigation schemes, state-owned housing, airports, sea ports, government buildings, and government farms

The State Sector Act of 1988

The State Sector Act shifted the operation of all government departments from a best-effort input budgeting regime to a monitored output targeting regime. This gave department heads unprecedented flexibility on how to achieve contracted and clearly defined objectives. The act turned on its head the idea that the civil service is the permanent government while elected legislators come and go. Instead, governments could campaign on a platform they would have the power to actually implement, without having to worry about pushback from the entrenched civil service bureaucracy.

The key was moving the national civil service to a performance management system rather than awarding each department a pile of money every year hoping they would do their best, and letting intentions guide the process rather than results. An essential element of this initiative was a change in the budget process that converted each appropriation into a "purchase agreement" that specifically detailed what the department was to produce. The teeth to this innovation was that the CEO of the agency could be terminated for not producing the outputs specified in the purchase agreement. In most intentions-driven systems, failures usually lead to calls for larger budgets and a repeat of the cycle of failure. Under performance management systems, failures more often lead to a sacking of the responsible bureaucrats and/or a re-examination of the premises and objectives of the program.

To enable this, all civil service employees were moved from job-for-life union contracts and a seniority based advancement regime to individual employment contracts and a merit based regime. At the beginning of each budget year, elected government ministers would contract with the heads of their departments via written performance contracts that explicitly stated which services or results the minister wanted to buy, how these results would be measured, and what the minister was willing to pay. The department heads then had sufficient autonomy to fulfill the terms of the contract as they saw fit, including the power to subcontract or outsource some or all of the work to the private sector. For the first time they had complete discretion to adjust their human resources to match the stated objectives, a chance that was welcomed by frustrated department heads. They were also greatly empowered and protected from second guessing. If the career department head had a better idea on how to deliver a service than the recently elected minister, he had the authority to make that call. But he would be held strictly accountable for the contracted results, knowing that his job was on the line.

For example, the defense department was obliged to account for all expenditures against the contracted mission. Each year, the department would have to produce an income statement and a balance sheet (more on that below) that included capital charges for real estate. This meant that maintaining a useless base for solely political reasons cost department chiefs real money. If they could sell off a base and redeploy forces to less expensive real estate, they had the power to do so.

Assembling and publishing the annual reports from all the government departments produced a constantly evolving picture that gave incumbent politicians, opposition politicians, taxpayers, and voters the ability to see if the country was actually getting its money's worth from government services. The effect was electric.

Ironically, the labor minister who came around to championing this reform, Stan Roger, had been the head of the public sector union. When he became a minister he knew exactly how dysfunctional the old system was. Despite concerns of union pushback, Stan was able to position the State Sector Act as a great liberation, setting civil servants free to professionally manage themselves to actually achieve results. "Stan played his cards close to his chest, and he did a great job keeping his people from marching down the streets too often," Roger Douglas recalls. The act worked because it ultimately gained plenty of champions inside the public sector, not always the department chiefs but able, bright people who knew that the status quo was a dumb way to do business. Nonperforming department heads were slowly eliminated, improving the lives of employees who were often pleased to see entrenched problem bosses disappear.

While some of the provisions of the State Sector Act were watered down by subsequent parliaments, particularly as they relate to deunionization, the core output monitoring target regime remains intact.

Key Provisions of the State Sector Act

Part 5 section 59: Employees of departments

1. In relation to the functions, duties, and powers of a department, the chief executive of the department
   a) may appoint such employees of the department (including acting, temporary, or casual employees) as the chief executive thinks necessary; and
   b) may, subject to any conditions of employment included in the employment agreement applying to an employee, at any time remove that employee from his or her office or employment; and
   c) has, except as expressly provided to the contrary in this act, the rights, powers, and duties of an employer in respect of the employees of the department.

Part 5 section 60: Appointments on merit

A chief executive, in making an appointment under this act, shall give preference to the person who is best suited to the position.

The Public Finance Act of 1989

If private businesses kept their books the way most governments keep their books, our jails would be full of CEOs. The purpose of the Public Finance Act was to transition all government accounting over to a more transparent and honest format by using the same generally accepted accounting principles (GAAP) required by businesses. This included a proper accounting of all long-term liabilities, funded and unfunded, as well as the recording and market-based valuation of every government asset and every piece of Crown property. Each functional area of government was required to produce both monthly and annual public financial reports. Nowadays, any analyst or citizen can find these documents on a publicly accessible government website.

Required annual audits made it harder to make farcical claims of balanced budgets since unfunded long-term liabilities, in particular future health-care and Superannuation (social security) obligations, cannot be hidden off the books or disguised with so-called "trust funds" made up of IOUs from the legislature promising future taxation, as they are in the United States. (Note that future investment returns projections can still be manipulated, a problem even in private pension schemes.) The proper enumeration of the value of Crown property also allows taxpayers to examine which public assets might be better sold off to private interests, both to put that property to higher use—for example, turning an unnecessary military base into housing and retail—or relieve the public debt.

As Roger recalls, this was quite an undertaking. "The first thing we had to ask ourselves was, what do we really own?" This actually took a bit of work, and in some cases revealed that the government didn't own some of the businesses it thought it owned. For example, it turns out that one of the insurance companies the government ran was actually chartered as a mutual company owned by its customers. Establishing proper valuations for state-owned enterprises and public property took place over a two-year transition period, which illustrates the magnitude of the challenge.

Key Provisions of the Public Finance Act

Independent accounting standards

The act requires that the financial statements (and financial forecasts) of the government and each individual department be prepared in accordance with generally accepted accounting principles (GAAP) in New Zealand. GAAP is an objective and independent set of rules that governs the recognition and measurement of financial elements such as assets, liabilities, revenues, and expenses. For example, GAAP requires that expenses and revenue be shown separately except in the limited circumstances where GAAP permits offsets.

The financial reporting standards that are the core of GAAP in New Zealand are approved by the Accounting Standards Review Board (ASRB)—an independent body established by the government. The ASRB approves standards for application by both the public and private sectors.

The government uses independently established rules for financial reporting in order to give users of reports a high level of confidence in the relevance and reliability of the information. The alternative, the government setting its own standards, was rejected because of the credibility issues that this would raise.

Notwithstanding the special characteristics of government, the government applies the same financial reporting standards as applied by other reporting entities in New Zealand. This means that public sector financial statements can be more readily understood by a wide range of people. It has also allowed the government to recruit accountants from the private sector and enhanced the ability of accountants to move from one sector to the other.

The 2004 approval of New Zealand equivalents to International Financial Reporting Standards by the ASRB has led to even greater harmonization of New Zealand's financial reporting standards with international standards.

Independent audit

Public sector organizations are accountable to Parliament for their use of public resources and for the exercise of powers conferred by Parliament. As part of its accountability requirements, Parliament seeks independent assurance that public sector organizations operate, and account for their performance, in accordance with Parliament's intentions.

The auditor-general provides this independent assurance to both Parliament and the public.

Appropriations

No expenses or capital expenditure may be incurred unless in accordance with an appropriation or other statutory authority.

Appropriations include limitations of amount, scope, and period. These limits are legally binding. All expenses and capital expenditure may only be incurred in accordance with these specifications, except in the limited circumstances where the act permits some variation to appropriations. Appropriations are also specified by type of expense or capital expenditure. The types of appropriations are output expenses, benefits or other unrequited expenses, borrowing expenses, other expenses, capital expenditure and expenses and capital expenditure of an intelligence and security department.

The auditor-general audits appropriations used and administered by departments and offices of Parliament to ensure that expenses and capital expenditure have been incurred in accordance with appropriations.

The Reserve Bank Act of 1989

After the 1984 devaluation of the kiwi, a pitched battle ensued to allow for a free float of the currency and for an independent but accountable central bank whose monetary policies could not be manipulated to serve the electoral agenda of the party in power. Because it was proposed by Roger Douglas of the Labour Party, Ruth Richardson had to fight a pitched battle to get the National Party to support it. (Philosophical deviance continued to prevail, with each party supporting policies that would have historically been associated with the other.) Roger was determined to remove the power of a sitting prime minister to goose monetary policy behind closed doors in the run-up to an election. Ruth believed that bipartisan support was essential to get financial markets to believe that New Zealand was serious about long-term reforms. Robert Muldoon, one of the worst offenders when it came to abusing monetary policy for political gain, continued to oppose the bill. Fate intervened on the day that the National Party caucus debated the issue when Muldoon was rushed to the hospital to deal with a medical emergency, allowing Ruth to carry the day. The bill passed with bipartisan support.

Unlike the US Federal Reserve Bank, which serves two conflicting mandates—price stability and full employment—the Reserve Bank Act commands that the New Zealand central bank serve only one mandate: price stability. The preamble to the act makes it clear that the government of the day may set the monetary policy framework (for example, a target inflation rate of 1 to 2 percent), which the Reserve Bank is responsible for executing. In practice this policy takes the form of a contractual agreement between the minister of finance and the governor of the Reserve Bank via a contract that must be tabled in Parliament and made public immediately after it is signed. The Reserve Bank governor remains the single decision maker under the law, not a committee. This allows the elected government to be held responsible for the policy and the Reserve Bank governor to be held accountable for the results; in fact the governor must tender his or her resignation if he or she fails to meet this contract.

Roger felt that the requirement to publish the policy target agreement, and any subsequent changes, is the single biggest factor that has averted political chicanery to this day, a recurring theme in establishing lasting reforms. Once policy making gets removed from the proverbial smoke-filled rooms and the public gets used to transparency, it's hard for a future government to take it away.

The other thing that makes the New Zealand banking system unique is that the government offers no bank deposit guarantees and takes no part in sustaining a too-big-to-fail banking culture. Banks are accountable to their own boards and if they fail, their depositors go down with them. This eliminates the moral hazard that allows reckless banks to use higher interests rates to attract depositors unconcerned about their bank's soundness. There are also no government sponsored enterprises (GSEs) dominating investment in the housing market like Fannie Mae and Freddie Mac in the United States. Hence, New Zealand never experienced a housing bubble. Again, following the rule of transparency, bank oversight in New Zealand is centered on the requirement that all banks publish independently audited risk profiles every quarter. (Other nonbank financial institutions do not have the same risk transparency and a number of them failed even as the banks weathered the storm. During the global financial crisis, Australian banks put a temporary government bank deposit guarantee in place, forcing New Zealand to match it lest its banks be drained of cash. Both are once again gone.)

Key Sections from the <u>Reserve Bank Act</u>

Part 2 section 8: Primary function

The primary function of the bank is to formulate and implement monetary policy directed to the economic objective of achieving and maintaining stability in the general level of prices.

Part 2 section 9: Policy targets

1) The minister shall, before appointing, or reappointing, any person as governor, fix, in agreement with that person, policy targets for the carrying out by the bank of its primary function during that person's term of office, or next term of office, as governor.
2) In the case of a person who is deemed to have been appointed as governor under section 191(1), policy targets for that person's term of office shall be fixed by the minister, in agreement with the governor, within thirty days after the commencement of this act.
3) Policy targets may be fixed for the term of office of the governor, or for specified periods during the term of office of the governor, or for both.
4) The minister and the governor may, from time to time,
   a) review or alter any policy targets fixed under this section; or
   b) substitute new policy targets for targets fixed under this section.
5) Where policy targets are fixed under this section,
   a) the minister shall ensure that they are recorded in writing; and
   b) the governor shall ensure that they are tabled at the first board meeting held after the date on which they are fixed; and
   c) the minister shall, as soon as practicable after they are fixed, publish them in the *Gazette* and lay a copy of them before the House of Representatives.

A year after the act passed, when the National Party won the government in a landslide, a top business journalist bet Ruth a case of the best French wine that her party would not be able to sign a conforming policy target agreement that would keep inflation between 0 and 2 percent. Ruth did that within two days of taking office as minister of finance and won the bet.

The Return of the National Party

Despite the accomplishments described above, or maybe even because of them, the Labour Party continued to descend into chaos in the years leading up to the 1990 election. At the end of 1988, David Lange took the unprecedented step of refusing to let Roger Douglas reappoint a member of his own staff. Finding this intolerable, Roger announced his intention to challenge David for the leadership of the party, publicly declaring that he would resign the cabinet if he lost. Thanks to the aforementioned increase in union influence in the caucus, David Lange prevailed and held on to the leadership of his divided party. Roger carried through with his threat and another three key ministers resigned in support.

The Labour Party's poll ratings immediately plummeted, going from 5 or 6 percent ahead of the National Party to 12 to 15 percent behind. In the subsequent interim intraparty cabinet election in 1989, Roger was again chosen by his colleagues to serve in the cabinet. David Lange took this as a vote of no confidence, at which point he resigned as prime minister. Worn out by the infighting, Roger chose not to stand for reelection in 1990, leaving the Labour Party forever. Shortly afterwards he went on to found ACT New Zealand, which became a new party dedicated to pursuing Roger's unfinished business, primarily directed at reforms in education, health, and welfare.

All of this drama handed the National Party its opening. Ruth and her allies ran against a flagging reform government not by promising retrenchment but by promising even more market-oriented reforms, including pledges to deregulate the private-sector labor market and deliver major public-spending cuts and major reforms in the welfare system. The electoral landslide that put the National Party in power was a clear mandate to continue.

This was Ruth's big opportunity. She challenged for the deputy leadership of the party. She lost by one vote and, as a consolation, was installed as the party's policy leader. This turned out to be a blessing in disguise because it allowed her to completely reshape the National Party platform. She convinced her colleagues to reject a return to Muldoonism and instead to follow through with promises to complete the reforms initiated by the now-exhausted Labour government. Her selling point was that the short-term pain would be tremendous but if the leadership had the courage to stay the course, the party would ultimately get credit for the harvest of jobs and growth.

It was an uphill battle. Matters came to a head when the incoming government discovered that the Bank of New Zealand was insolvent and the forecast budget surplus was a mirage. Once again, thanks to the fact that the budgeting process remained cloaked in secrecy, incumbents couldn't resist the temptation to cook the books. This lack of transparency was a structural problem Ruth was determined to fix.

But before new reforms could be implemented, dramatic action was required to stave off default. Within six weeks of assuming her position as minister of finance, Ruth began slashing government spending. Importantly, she also introduced an emergency statement deregulating the private-sector labor market, giving the economy as much flexibility as possible to wean itself from government distortion and dependence. This was something the Labour Party could never do—despite its bold reforms of the public sector via the State Sector Act—because this would have been a step too far for a party that still had close ties to union interests. This emergency decree was eventually followed by the Employment Contracts Act of 1991, which ended government support for compulsory union membership, replacing it with a liberalized regime of individual employment contracts. Union membership plummeted, with a concurrent rise in productivity and flexibility that contributed significantly to economic growth.

Key Provisions of the Employment Contracts Act of 1991

- The Employment Contracts Act gave all citizens the absolute right to join or not join a union as they saw fit. Union membership could not be held as a condition of employment.
- Both employees and employers were given the right to choose whether and which third party agent they wanted to use to negotiate their employment contract.
- Multiemployer collective contracts were replaced with individual contracts whose type and content were a matter of free negotiation.
- Only the direct parties to a contract had standing to take legal action in the event of a breach.
- Strikes were only lawful once a contract had expired during negotiations for a new contract.
- A new Employment Tribunal and a new Employment Court were empowered to adjudicate disputes.

The new government was off to a good start when the next crisis hit. The Standard & Poor's bond rating agency was threatening to subject New Zealand's debt to a double downgrade. This would have had a devastating effect on the country's borrowing costs. With cries of "over my dead body" Ruth grabbed the secretary of the treasury, the head of the government debt management office, and the government's chief macroeconomic adviser and got on a plane headed for New York to make the case for forbearance. When they landed in Los Angeles to change planes, the first Gulf War broke out. This put the whole world on edge, nervous that a spike in oil prices could trigger global recession.

The next morning Ruth and her team went eyeball to eyeball with a stone-faced committee of five at Standard & Poor's. To Ruth's good fortune, two of the committee members were women. "I played the sisterhood card," recalls Ruth, laying it on thick. "Look," she said, "I'm the first female finance minister in New Zealand's history. I've made so many tough calls I need police protection around the clock. I am absolutely doing the right thing to get this fiscal mess sorted out, and the last thing I need from you is a double downgrade."

The S&P committee was noncommittal at the end of the meeting. But when the negotiation team landed back in New Zealand they learned that S&P had decided on just a single downgrade. By playing all her cards expertly, while controlling her message, Ruth had dodged another bullet.

1991 rolled around, making it time for Ruth to introduce her first budget. She whimsically dubbed it the "mother of all budgets," a nod to the mother of all battles making news in the Gulf. Critics were aghast at her boldness. This was the last transition budget moving the government toward full compliance with GAAP accounting standards, as required by the Public Finance Act.

There are only three things that drive public spending in New Zealand: entitlements, health care via the National Health Service, and education. (New Zealand has a tiny defense department so there was little to cut there.) They all went on the block.

> The National Health Service
>
> Like the United Kingdom, New Zealand has a mixed public/private health-care system with about 75 to 80 percent of national health-care expenditures coming from the government (taxpayers) and the balance coming from private payers or secondary private insurance purchased by those who want higher-quality services not subject to rationing by

> waiting lists. About 20 percent of the population is covered by supplemental private insurance.
>
> A government-run Accident Compensation Corporation pays for treatment as a result of anything deemed an accident, covering both residents and tourists. According to the Legatum Prosperity Index, New Zealand ranks twentieth out of 142 nations in health, its worst performance category.

The mother of all budgets was ugly, but for the first time it exposed the nation to the hard truths. These truths didn't require just short-term spending cuts. Long-term expenditure drivers also had to be restructured. Sacred cows were sacred no more. Unemployment benefits were slashed, reducing the moral hazard that induced the young to extend childhood at the government's expense, adding to society's burdens, reducing payroll taxes, and destroying human capital. The age to collect retirement benefits was raised, albeit in stages to soften the transition. And the biggest sacred cow of all, the Superannuation, or social security benefit, was partially subject to means testing. This ensured that old-age support would increasingly focus on the truly needy and not the comfortable middle class, the most expensive segment of any social security system. Prime Minister Jim Bolger howled as this broke one of his campaign promises, but Ruth faced him down.

Critics erupted, labeling her policies "Ruthanasia." As poster child for the bitter medicine being administered, Ruth became the most hated politician in New Zealand. Effigies were burned in the streets, protesters poured a pot of blue paint on her (she saved the ruined dress for a charity auction), and police had to protect her on her jog to work every morning.

But the reforms started to work. A sharp recession in 1991 cleared out the prior economic malinvestment and an era of economic growth commenced. Ruth's 1992 budget was the first national budget in full compliance with GAAP standards, a practice that remains sacrosanct in New Zealand to this day. No more lying with numbers, no more obfuscation of long-term liabilities, no more kicking the can. The country was going to be run more like a successful business than a public pork piggy bank.

The reforms started to turn the tide. But with an election coming up in 1993, Prime Minister Bolger got cautious, hitting the brakes on further reforms. Ruth's role switched from being a champion of reform to fighting to avoid the political unraveling of all she had accomplished. The only way to do this was to institutionalize the process of honest budgeting, holding politician's feet to the fire during election season to avoid falling back into the trap of promising voters goodies that had to be paid for by future taxpayers.

Ruth spent the first part of 1993 making the case for a Fiscal Responsibility Code that would embody these practices. The Treasury Department was skeptical, but supported Ruth's efforts to introduce legislation. While most of her colleagues didn't understand her approach to locking future ministers into a transparent discipline, it was this transformative step that locked the earlier reforms in place.

The Fiscal Responsibility Act of 1994

Principles of responsible fiscal management

Governments are required to follow a legislated set of principles and publicly assess their fiscal policies against these principles. Governments may depart temporarily from the principles but must do so publicly, explain why they have departed, and indicate how and when they intend to conform to the principles. The five principles of responsible fiscal management are

a) Reducing total Crown debt to prudent levels so as to provide a buffer against factors that may impact adversely on the level of total Crown debt in the future, by ensuring that, until such levels have been achieved, the total operating expenses of the Crown in each financial year are less than its total operating revenues in the same financial year.
b) Once prudent levels of total Crown debt have been achieved, maintaining these levels by ensuring that, on average, over a reasonable period of time, the total operating expenses of the Crown do not exceed its total operating revenues.
c) Achieving and maintaining levels of Crown net worth that provide a buffer against factors that may impact adversely on the Crown's net worth in the future.
d) Managing prudently the fiscal risks facing the Crown.
e) Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

Definitions such as "prudent" level of debt, or "reasonable" degree of predictability are not specified in the act. It is left to the government of the day to interpret the relevant fiscal terms. Importantly, although a government can depart from the principles, the FRA requires any such departure to be temporary and that the minister of finance specify the reasons for departure, the approach to be taken to return to the principles, and the period of time this is expected to take.

Reporting requirements

Governments must publish a Budget Policy Statement (BPS) before the annual budget and a Fiscal Strategy Report (FSR) at the time of the budget. These publications must demonstrate the consistency of the government's

> short-term fiscal intentions and long-term fiscal objectives with the principles of responsible fiscal management. The act requires the FSR to include fiscal projections (the "Progress Outlooks") covering a minimum of ten years for the variables specified as long-term fiscal objectives.

The National Party won the 1993 elections by one seat. The prime minster felt emboldened to abandon further reforms. He told Ruth she could remain in the cabinet as any minister *except* the minister of finance. "I'm not in politics for its own sake," Ruth informed him. "I've come here on a mission for the people of New Zealand. I believe you are wrong, I don't respect your decision and I'm going to resign my cabinet position and go back to the finance and expenditure committee until the Fiscal Responsibility Act passes."

Once again, because Ruth made the majority that kept the National Party in power, all hell broke loose. She used her leverage to get the Fiscal Responsibility Act across the finish line. The day after it passed Parliament, Ruth resigned her seat and left political office forever.

In 1994, New Zealand had the highest rate of job growth in the OECD.

The Aftermath

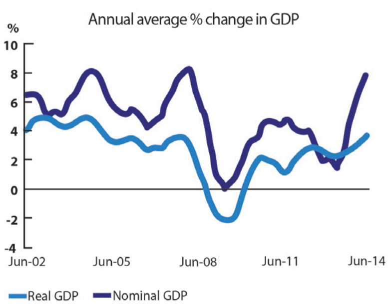
Twenty years have passed since this political drama played itself out. How has New Zealand fared since then? And, as debt-laden and growth-retarded democracies struggle with many of the same issues New Zealand faced during its days as an economic basket case, what lessons can we draw from the country's political transformation?

First, a few facts. New Zealand's GDP has grown from US$46.3 billion in 1993 to US$182.5 billion in 2013, a fourfold increase. The national debt slowly declined from about US$25 billion in 1993 to US$15 billion in 2007, a record to be admired. An unexpected consequence of the Fiscal Responsibility Act was that it did not foresee the temptation that annual surpluses during times of prosperity would present to Labour governments. This allowed them to ramp up spending commitments when they came into power, which made it harder to adjust to the global recession of 2007 and led to a short-term debt binge. Even so, the net government debt to GDP ratio is about 30 percent, a manageable number compared to about 90 percent for the United States and over 100 percent for Italy, Portugal, Greece, and Japan. The unemployment rate peaked at about 11 percent in 1993, trending down to under 4 percent when the global financial crisis hit in 2008. It is now just under 6%.

A Snapshot of the 2014 New Zealand Financial Statements

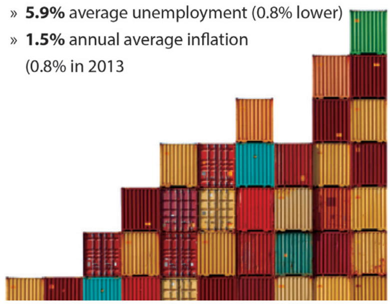
The economy continued to grow

Real gross domestic product growth accelerated to an annual average rate of 3.5%, with strong growth in construction, primary industries and some services. Nominal activity strengthened 7.8%, as export princes increased.



Facts and figures - June Year

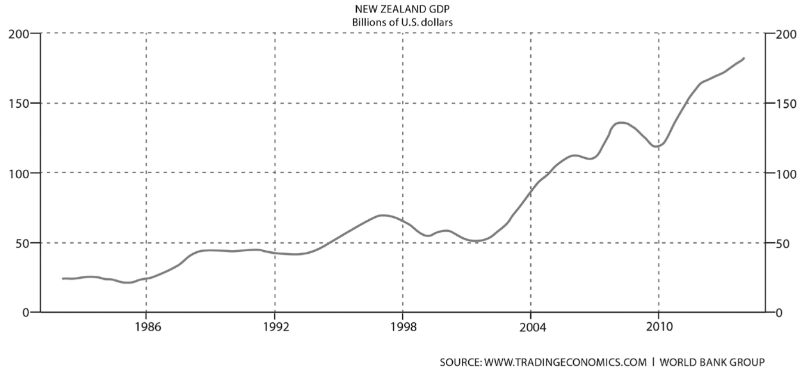
- **$229.1 billion** nominal GDP (up 7.8%)
- **$154.0 billion** real GDP (up 3.5%)
- **$68.5 billion** export receipts (up 9.8%)
- **1,399,200** average full-time employees (38,500 more)
- **$28.11** average hourly rate (up 2.6%)
- **5.9%** average unemployment (0.8% lower)
- **1.5%** annual average inflation (0.8% in 2013)

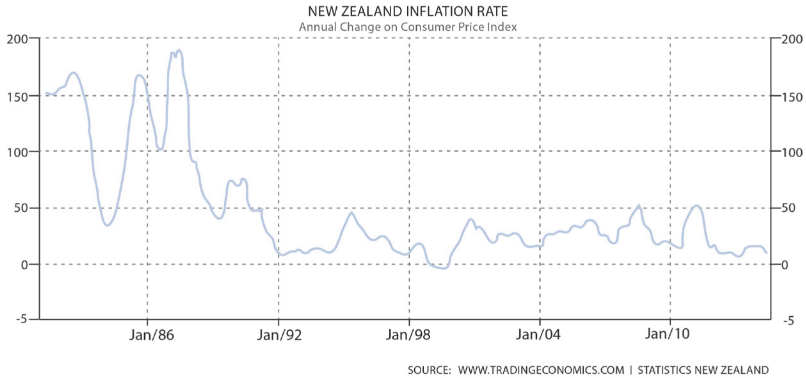


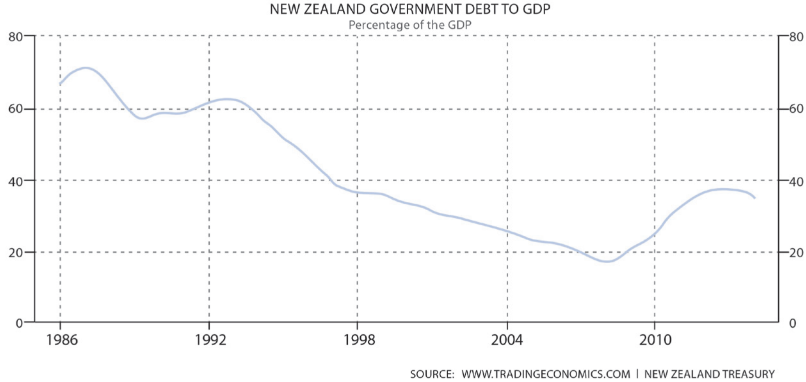
New Zealand's top marginal personal income tax rate was 66 percent when Roger Douglas took over as minister of finance. It was 33 percent by the time Ruth resigned from that office and remains 33 percent today. The corporate tax rate is a competitive 28 percent. Capital gains taxes and inheritance taxes were abolished. An ad hoc and incoherent national sales tax system was shifted to a broad and comprehensive sales tax, currently at 15 percent, with few exceptions. The shift away from heavy reliance on income taxes toward a more balanced mix that includes consumption taxes has had a dramatic effect on economic growth, tax revenues, and savings. Less visible, but equally important as lower tax rates, is the policy shift away from using the revenue system to incentivize economic and social goals. With virtually no deductions, except for those that are a direct cost of earning income, many of the previous distortions in decision making have been removed. Compliance is easier and tax avoidance more difficult. Most importantly, tax policy is stable, predictable, and straightforward, which reduces the corrupting influence of special interests that compete for tax favors.

Trade is flourishing, in particular with China. Since New Zealand became the first and only OECD country to conclude a free-trade agreement with China, it has become the country's second largest trading partner. Chinese factories crank out electronics, clothing, furniture, and toys that raise the standard of living of its customers in New Zealand. Meanwhile, New Zealand leverages its comparative advantages by satisfying the growing appetite of China's middle class for high-quality protein. Thanks to free trade, there is no reason for New Zealanders to have to sacrifice material comforts to live in a verdant and thriving agrarian state that would have made Thomas Jefferson proud. The 2014 Index of Economic Freedom makes the case, ranking New Zealand fifth in the world, behind Hong Kong, Singapore, Australia, and Switzerland with ratings of 90 percent or higher for rule of law, freedom from corruption, business freedom, and labor freedom.

New Zealand Economic Indicators







The bottom line is that while New Zealand's politicians haven't fundamentally changed—the species is pretty much the same the world over—politics has. Despite the fact that the finance minister that succeeded Ruth when she left the cabinet in 1993 was in the vanguard of Muldoonism, he was bound by the key pillars of legislation put in place. He couldn't take the party back to its destructive ways. Of course there has certainly been backsliding, economic ups and downs, and unpredictable events (such as the disastrous Christchurch earthquake that required dramatic emergency relief). Nonetheless, most elections since the mid-1990s have been carried out against a backdrop in which both parties try to outdo each other with claims that they will be more fiscally responsible than the other. Interestingly, the move to GAAP accounting made it easier for the media to report on the impact of government policies by focusing on the single Net Position figure, a number that the electorate watches like a hawk. Driving the country back into chronic deficit has become the third rail of politics.

This is not just because the political culture changed, or that the fruits of all these reforms delivered levels of economic prosperity never before experienced in New Zealand. It's not just because honest GAAP accounting continues to deliver dividends. It's because the overall policy framework is based on high-quality information and transparency, which leads to direct political accountability. A rhythm of public disclosure is respected by both parties during each election cycle. It starts with standardized briefing documents provided to every incoming government. All players in the game are constrained to operate under the limits imposed by the **State Sector Act**, the **Reserve Bank Act**, the **Public Finance Act**, and the **Fiscal Responsibility Act**. Although it may take an extraordinary set of circumstances and people to construct such a set of behavioral norms and legislative constraints on government, New Zealand's experience proves that broken democracies can repair themselves and that they need not slide into despotism, the trajectory followed by many failed democracies throughout history.

New Zealand's success is not only widely recognized but stands as a matter of national pride. What other Treasury Department sells a T-shirt emblazoned with the words "The greatest little Treasury in the world"? Contemporary political news articles still recognize the fact that Sir Roger Douglas and Ruth Richardson—finance ministers from opposing parties who nonetheless pursued the same principles—saved New Zealand from disaster.

Observations and Recommendations

The story of how Roger Douglas and Ruth Richardson, finance ministers from opposing parties, reformed New Zealand and put the country on a path to prosperity is certainly inspiring. It demonstrates, once again, that true leadership can convince a nation to make short-term sacrifices to achieve long-term goals.

We close with observations and recommendations we can take away from New Zealand's successful reform initiatives, if the goal is to answer the following questions:

(1) What are the key policies and rules needed for a democracy to flourish economically?

(2) How does a sick democracy—caught in a downward spiral of deficit spending and inflation, unfunded liabilities, and intergenerational theft—chart a political path to recovery?

The first question is easier to answer as the underlying principles of success have been amply demonstrated in various locales across multiple centuries. These success principles are not unique to governance; they also apply to private industry and personal flourishing, and have been debated and discussed by economists, philosophers, and theologians for millennia.

The second question is more difficult because it's possible that New Zealand succeeded under a unique set of circumstances. That makes it risky to extrapolate to different nations and systems of governance that operate under widely varying circumstances. It also requires more prescription than description. We will offer some ideas but suggest a degree of humility as history provides scant comfort. Despite ample warnings, most failing democracies wait far too long to heal themselves.

Descriptive Observations

The list of success factors required for a democracy to flourish economically is not long: honesty, integrity, transparency, accountability, efficiency, thrift, prudence, flexibility, freedom, leadership, and courage. Does anyone care to stand up and deny that these are virtues not just of good government but of a good life? Although universally acclaimed by economists, philosophers, and theologians, why are these virtues so hard to find in governments and politicians?

It's not because politicians are inherently wicked, though some undoubtedly are. It's because even the most well-meaning politicians are human, which means they respond to incentives. If they are rewarded for lying, they will lie. If they are rewarded for sacrificing their integrity, they will become duplicitous. If they are rewarded for obscurantism, inefficiency, unaccountability, and profligacy, that is how they will behave. If they are permitted to sacrifice their citizens' freedoms to satisfy their will to power, it is only a matter of time before that happens. And although almost all politicians enter office with a pledge to pursue the common good, a comprehensive system of perverse incentives eventually sets them on another course. An entire theory of government going by the name Public Choice Theory lays out the operation of these forces in great detail. These will not be recounted here.

The sad truth is that most majoritarian democracies reward politicians with the prize they covet most—winning the next election—not for exhibiting universally admired virtues or even serving the public good. Instead, they are rewarded for dispensing largess to their particular constituents, and doing so in a way that disguises the costs not only to others but to those constituents and sometimes even themselves. *This* is the problem that New Zealand fixed.

Protectionism, subsidies, and special privileges sow the seeds of destruction for the industries they were intended to help. Central planning rarely fails due to lack of good intentions but rather for the moral hazards it creates, the inability of centrally planned economies to adjust to changing conditions, and the destruction of the machinery of innovation that drives genuine progress. Only the creative destruction of free and open competition can clean up institutions as diverse as too-big-to-fail banks, horridly run inner city school systems, and badly managed sheep farms. New Zealand broke the stranglehold that many failed public and private institutions held on the government whose primary interests were to maintain privileges that protected them from competition.

Despite the hue and cry raised by the various special interests whose oxen are gored by reform, it is internal contradictions that lead to the collapse of bad policies, not media-enabled whining by special interests. Roger Douglas is keen to point out that despite all the blame laid on the reforms that he and Ruth enacted twenty-five years ago for the passing troubles that came New Zealand's way, none of the core reforms have been undone because *they worked*.

In today's global economy only nations that engage in free trade can be expected to prosper and thrive, exploiting their unique comparative advantages through voluntary exchange. New Zealand was blessed in that its natural advantages dovetailed with emerging China's explosive appetite for high-quality protein (New Zealanders call milk, which they produce in abundance, "liquid gold"). But even countries with no agriculture or natural resources like Hong Kong, Singapore, and Dubai thrive thanks to free trade. High import tariffs, restrictive quotas, and onerous licensing regimes serve only to enrich the connected few at the expense of the hardworking many. History is replete with nations that thrived thanks to free trade, from the early Phoenicians to Genoa, the Netherlands, England, and the United States. And now, New Zealand.

Prescriptive Recommendations

These are the key points in Roger and Ruth's battle plan:

- **Demand honest accounting, the bedrock of good governance**

Take a look at the books of almost any developed democracy and you will find an intentionally incomprehensible mess, designed to allow politicians to make preposterous claims about the costs of the promises they've made in order to win and keep office. It doesn't matter whether the constituents are welfare recipients or defense contractors. Politicians of all stripes and parties will hide the true cost of government if they are allowed to get away with it.

By insisting that all government financial statements conform to GAAP accounting, New Zealand broke the mold. While this transition inflicted short-term pain on members of both dominant political parties, honest accounting continues to deliver long-term benefits to the nation. Of all the reforms enacted by New Zealand that can ameliorate the bad practices of governments worldwide, this one should be at the top of the list.

- **Encourage transparency between parties, and between the government and the people**

It's one thing to keep honest books using proper accounting. It's another to make sure these books are accessible and not locked behind closed doors. By insisting on total transparency—in the

Internet age this means requiring every major functional area of the executive branch to publish monthly financial statements on the web—New Zealand removed the ability for the party in power to hide bad news from rivals, constituents, analysts, bondholders, and even itself.

- **Create stability through sound money and explicit monetary policy**

Central bank discretionary monetary manipulation has been the undoing of governments since Rome debased its coinage. This carnage results from both malinvestment driven by artificially low interest rates, which pump up asset bubbles that inevitably burst, and widespread inflation. New Zealand has become a model of monetary rectitude by insisting that its central bank have a single mandate—price stability—and that inflation targets be set and published by the government in power and executed by a single accountable central bank governor through a negotiated and published agreement. The country has not eliminated the business cycle. But the exaggerated booms and busts that have come to characterize much of the rest of the world seem to have passed New Zealand by.

- **Use performance management based civil service reform to deliver results**

New Zealand reformed its civil service by replacing job-for-life union contracts and a seniority-based advancement regime with individual employment contracts and a merit-based system. Then it shifted from an input-driven budget management system to an output-driven system, which allows ministers to contract with the agencies under their responsibility and demand measurable deliverables. Finally, it gave the chief executives of these agencies the flexibility to fulfill those contracts as they saw fit, holding them responsible for the results. Essentially, each administrative agency began to function as a corporation, with the elected minister serving as chairman of the board and taxpayers as shareholders. When coupled with honest accounting and public transparency, the results were electric.

- **Leverage private-sector labor reforms to open the economy**

New Zealand's governmental reforms worked and its citizens were able to navigate the transition from dependency to freedom only because private-sector labor laws were reformed too. As is evident in Europe today, sclerotic labor laws that turn employees from assets into liabilities discourage hiring. When you couple this with regulations that hamstring innovation and retard market entry, a country is bound to become mired in high unemployment and slow growth. This leaves it with insufficient flexibility to respond to changes in global market demands. New Zealand's economy soared because it set both employers and employees free to contract as each saw fit, unimpeded by forced unionization and other labor and compensation standards that had rendered the country's businesses inefficient and uncompetitive.

- **Never let a crisis go to waste**

Attempts at significant reform are often driven by crisis. The challenge is that crises create both opportunities and peril. Traditionally, politicians successfully divide and rule by pandering to specific identity groups to the detriment of the whole. The tactical takeaway from Richard and Ruth's story involves inverting the paradigm. Reformers need to figure out how to deliver broad benefits that are enjoyed and seen by enough of the electorate to maintain political momentum. While not easy, by using some of the ideas below it can be done. (Readers interested in diving into this subject further should read a paper presented by Roger Douglas to the Mont Pelerin Society in 1989 called the "Politics of Structural Reform," from which much of the remaining material is drawn.)

- **Comprehensive reform trumps piecemeal reform**

Whether you are a farmer receiving crop subsidies, an energy company getting special tax treatment, a civil servant with lifetime tenure, or a welfare recipient being paid not to work, piecemeal reforms create an imbalance between the modest long-term savings delivered to the many and the jarring short-term shock experienced by the few. As a result, a vocal minority can concentrate its energies on blocking change. But when reform is comprehensive and many different kinds of government subsidies are removed simultaneously, the political calculus shifts. A cacophony of voices—each trying to preserve their own privileges at the expense of others—tend to cancel each other out. The disgruntled soon learn to point to additional groups with special privileges that should also be thrown off the dole, a welcome development. As momentum builds and the scope of reform grows, the sum of the long-term benefits accumulate to the point that these can alleviate much of the short-term pain. This virtuous cycle becomes particularly powerful when the economy grows upon being relieved of the dead weight. As Roger Douglas puts it, "whatever their own loss, each individual group also has a vested interested in the success of the reforms being imposed on all the other groups."

- **Reforms must be evenhanded**

Every special interest group exempted from reform for political considerations creates a model for other groups seeking similar protection of their privileges. While a commitment to evenhandedness may force political leaders to bite some of the hands that feed them, strong leaders can use comprehensive reform and the benefits delivered thereby to dull the pain. In addition, reducing exceptions to reform minimizes vulnerability to charges of hypocrisy.

- **Flood the zone to create too many moving targets to effectively oppose**

Big packages that combine quantum leap reforms force the opposition to prioritize. Like a hawk attacking a flock of birds, they may pick off one or two but they can't get all of them. In addition, opposition groups can be set against each other via policy linkages that make it painful to undo certain reforms or award special benefits as this would impose visible costs on well-identified rivals (rather than invisible costs on the taxpayers at large). As privileges are being removed from one group, this group's resentment that privileges are not being removed fast enough from other groups can be harnessed for political gain.

- **Speed is of the essence**

Once reformers gain the upper hand, delay becomes the enemy. Delay allows the opposition to organize and raise procedural roadblocks designed to distract, divert, and bog down reformers. The faster reforms progress, the sooner tangible results begin to accrue, offsetting the initial pain. In the end, action must be fast enough for the benefits to arrive before support for reform collapses. Giving certain constituents more time to "adjust" only encourages others to demand the same, which threatens the whole package.

- **Resolve is essential**

While few in New Zealand accepted all of the many reforms that took place, most were convinced they had no alternative. "People had come to believe that this was a government that didn't blink," recalled Roger. "And that's terribly important, because if you blink, all the energy of your opponents becomes focused on getting you to change your mind. If they believe that you're not going to blink, then their energy is focused on how they are going to cope with and adapt to the changes." Roger points out that in government, just as in business, it is uncertainty and not speed that causes problems dealing with change.

- **To win requires managing the narrative**

As Roger Douglas puts it, "the dog must see the rabbit." That is, when pursuing change, reform leaders must craft and promote a narrative using quality messaging that describes the breadth and arc of the program as it unfolds, and this narrative must be seen as coming to pass each step of the way. This is a very different approach than using lies to pursue reforms whose ultimate goals are hidden for political reasons. "Voters want and need politicians with a vision and the guts to create a better future," Roger sums up, "even if they don't agree with each and every policy." He further recommends that when programs have to be implemented over stages, publish timetables and then stick to them. The issuance of waivers and special exemptions destroys credibility and breeds resentment.

- **Consult widely to get input and buy-in**

It is easy to fall victim to willful blindness and self-defeating hubris when you only seek input from those who agree with you. While New Zealand's decade of reform was both bitter and contentious, its key principles had support that crossed party lines, and cabinet leaders pursued deep involvement with the private sector. Roger Douglas passed the baton to his counterpart in the opposition when the Labour Party lost power. Rather than setting to work undoing all his reforms, Ruth Richardson doubled down, often relying on support from the same private-sector interests that had backed Roger. This could only happen if key leaders in both parties shared a set of rational beliefs about how the economy functioned, beliefs supported by leaders in the private sector impacted by reforms. This is, perhaps, the hardest challenge in our age of political hyperpolarization. It implies a need to find leaders who can appeal beyond their own narrow base, to members of the opposition as well as business leaders who ultimately pay the price if politicians get things wrong.

- **Confidence in leaders rests on their own visible relaxed composure**

Perhaps Winston Churchill best exemplified the concept of "keep calm and carry on" as bombs rained down upon him and his people. One of George Washington's key talents was stoically sitting on his horse exposing himself to danger, to make sure his defeated soldiers conducted orderly retreats so they could live to fight another day. These leaders understood that their own demeanor and the tone in which they communicated projected visual and emotional cues that their followers relied on to keep them moving forward. "Visible uncertainty spreads like the plague," says Roger. Most of all, powerful historical figures understand that they must be leaders of all the people, not just of their faction or panderers to a shifting alliance of identity groups or special interests.

- **Never sell the public short**

Abraham Lincoln famously reminded us that you cannot fool all of the people all of the time. Holding off the demagogues and opportunists eager to block reform requires respecting the public's ability to shoulder the short-term hardship required to achieve long-term gains. This is not a matter of appealing to abstractions like patriotism, altruism, or self-sacrifice, but of convincing people of the logic of reform by explaining and then demonstrating the costs and benefits of sound policy measured against their own self-interests. To pull this off requires all of the principles and tactics described above, plus one more thing.

- **Institutional disciplines must be established that outlive the reformers**

Episodes of reform can be inspiring; however, history has shown that no legislature can bind a future legislature. But the right structural changes can erect roadblocks to backsliding. Ruth sums it up: “If you bound public policy with a series of institutional disciplines, this will go on yielding good results despite indifferent administrations that have to operate within that framework. You can get there if you pursue coherent and comprehensive reform, your communications are of a high caliber, and you champion the cause. That’s winning politics.”

The Saga Continues

New Zealand today operates under a system described as designed by Hayekians, run by pragmatists, and populated by socialists. Does this mean that New Zealand has solved all its problems? Of course not. Health, education, and retirement policies continue to suffer from the usual depredations of denial, demagoguery, marginal adjustments, and budget gimmicks. Readers who are interested in that ongoing struggle might want to read Roger Douglas's book *Unfinished Business*. The country also has native ethnic minority issues that continue to fester. The capacity to resolve these problems is a lot easier when a country is experiencing economic growth and fiscal strength, rather than mired in a zero-sum fight over a diminishing pie. This is where Japan, Europe, and even the United States are unfortunately headed if they don't heed these lessons from this little country that could.

Internet Resources

ACT New Zealand

www.act.org.nz

Employment Contracts Act

bit.ly/EmploymentContractsAct

Economic Indicators

www.tradingeconomics.com/new-zealand/indicators

Financial Statements of the Government 2014 Snapshot

www.treasury.govt.nz/government/financialstatements/yearend/jun-14snapshot

Fiscal Responsibility Act 1994

bit.ly/FiscalResponsibilityAct94

Fraser Institute Economic Freedom of the World Reports

www.freetheworld.com/reports.html

Index of Economic Freedom 2014

www.heritage.org/index/download

Legatum Prosperity Index

www.prosperity.com

Public Choice Theory

www.econlib.org/library/Enc/PublicChoice.html

Public Finance Act 1989
bit.ly/PublicFinanceAct89

Reserve Bank of New Zealand Act 1989
bit.ly/ReserveBankofNewZealandAct89

State-Owned Enterprises Act 1986
bit.ly/State-OwnedEnterprisesAct86

State Sector Act 1988
bit.ly/StateSectorAct88

Treasury
www.treasury.govt.nz/

Treasury – Independent accounting standards
bit.ly/IndependentAccountingStandards

World Bank – GDP per capita
data.worldbank.org/indicator/NY.GDP.PCAP.CD

World Economic Forum – Global Competitiveness Report 2014-2015
www.weforum.org/reports/global-competitiveness-report-2014-2015

World Justice Project Rule of Law Index
data.worldjusticeproject.org/#/index/NZL

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About Antigua Forum

The Antigua Forum is a project of Universidad Francisco Marroquín in Guatemala. The heart of the project is an exclusive, annual gathering of political reformers and entrepreneurs from around the world who believe in the power of human ingenuity and free enterprise to dramatically improve the well-being of people everywhere. The Antigua Forum case studies series highlights specific experiences of reformers and entrepreneurs, digging deep to understand the processes they followed and the lessons learned.

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