



# Can New Zealand Fly Again?

## The New Reform Agenda

**A**s the New Zealand Labour government's Minister of Finance between 1984 and 1988, SIR ROGER DOUGLAS was responsible for introducing radical and wide-ranging economic reforms—dubbed 'Rogernomics'—that liberalised the economy and laid the basis for a revival in the country's flagging fortunes. The author of *There's Got to be a Better Way* (1981), *Unfinished Business* (1993) and *Completing the Circle* (1996), he is now Managing Director of Roger Douglas Associates, an international consulting firm specialising in advice on economic restructuring and structural adjustment. He spoke here with SUSAN WINDYBANK about the new reform agenda in New Zealand.

**Susan Windybank** is Editor of *Policy*. Her last interview for *Policy* was with Owen Harries for the Autumn 2002 issue.

**Susan Windybank:** It is close to 20 years since the start of the liberal reforms that halted New Zealand's decline relative to other OECD economies. But the economy now appears to have lost steam and NZ risks slipping behind again. Are you disappointed that the era of free market reform did not achieve more?

**Sir Roger Douglas:** The era of reform was a tremendous success. Total exports increased by 20% in the four years to 1996. Manufacturing exports grew very rapidly. As a percentage of total sales they reached around 45%, only slightly behind Taiwan, demonstrating that growth was driven by international competitiveness and not just the local market. Investment went up by 70%. Moody's upgraded their rating while Standard and Poors said that New Zealand's fundamentals were unprecedented and unparalleled. International investors saw New Zealand as a location for business serving not just the New Zealand market but the Australian market and parts of the Asia Pacific region. Port handling charges went down by 60%, and rail freight costs dropped by 50%. We had 0-2% inflation, and GDP growth in 1994 was just over 6%. By 1996, New Zealand was doing incredibly well. Evidence of this can be seen in the publication of the Geneva-based World Economic Forum's *World Competitiveness Report* for 1996, which ranked New Zealand third in its international survey of competitiveness.

The problem was the stopping of reforms, and in some cases the reversal of them. After Finance Minister Ruth Richardson left the Bolger government, control on public expenditure collapsed. From 1994 onwards, spending on health and education and welfare increased, transferring resources from the high productivity private sector to the low productivity public sector. This rise in government spending, along with changes to the labour market and the Resource Management Act, put a brake on growth. It also sent a signal that New Zealand was not as good a place for investment as it had been previously, and we started to go down again.

**SW:** With the benefit of hindsight, would it have been better to take a more incremental approach to reform rather than the 'big bang' approach that you favoured? Do you think people need time to

adapt and learn until the new rules sink in—or to put it another way, that reformers should allow for a lag between top-down changes and bottom-up adjustment?

**RD:** No. Speed is essential. In my view, it is almost impossible to go too fast. Even at maximum speed a reform programme will take years to implement. The short-term trade-offs in any major programme of change start from day one. When reform has been delayed for many years, the costs are considerable and tangible benefits take time to appear. If action is not fast enough, the consensus supporting the general reform programme can collapse before the results become evident and while the government is still halfway through the reform programme. Once reform is started, it should not stop until it's completed. The fire of your opponents is less accurate if you are moving quickly.

There are serious dangers in seeking to hold back the rate of change to satisfy groups who claim that a slower pace would give the community more time to adjust. Policies cannot be fine-tuned with enough precision to ensure that, for example, inflation is reduced successfully by a modest targeted amount every year over an extended period. The other thing we learned is that vested interests continuously underestimated their own ability to adjust successfully in an environment where the government was removing privileges across the board. On closer analysis, many demands for a slower pace were actually expressing powerful resentment that the government was not moving fast enough to abolish group privileges.

The political lesson is quite simple. It is uncertainty not speed that endangers the success of a structural reform programme. Speed is an essential ingredient in keeping uncertainty down to the lowest possible level.

### The next wave

**SW:** You have recently proposed radical changes to education, health, welfare, risk management (such as accident and sickness cover) and superannuation. Why the shift from economic to social reform?

**RD:** Because the biggest unfinished business in

New Zealand is in the social policy area—health, education, risk management (unemployment, sickness and accident insurance), welfare (such as single mother benefits) and retirement (superannuation).

If you ask any New Zealander which services provided by the government they are most unhappy about, they will inevitably answer health first, followed by education. Some 20% of New Zealanders are classified as ‘functionally illiterate’ when they leave school but people can’t do much about it because of the strict zoning policy the government has introduced, which means they can’t move their children from one school to another. Pressed further they would probably add superannuation and deteriorating law and order to that list.

**SW:** You say that health and education are failing, so how would you put them right?

**RD:** The problems in the health and education system stem from the deeper problem of welfare—unemployment, single mother benefits and so on. I’m in favour of school choice and privatisation of health but I’m not sure it’s going to help the youngsters who come from dysfunctional families, many of whom are welfare-dependent. Addressing low education standards simply by removing state dominance in education is not enough. Likewise, allowing private insurance to play a major role in the risk management of health, accident and sickness policies, while an excellent beginning, is not going to solve the deeper problem, which starts in the home.

Roger Douglas visited Sydney during 2003



Fixing the cause of our poor educational, health and crime outcomes involves not only finding ways to improve the health and education systems *per se*, but also finding much more effective ways of dealing with welfare, particularly sole parents.

Thirty years ago the number of people receiving the single mother allowance in New Zealand was around 10,000. Now it’s 110,000. Before, those 10,000 had 20,000 children, today those 110,000 have approximately 190,000 children. While some single parents do an outstanding job, many don’t. This means that fixing the cause of our poor educational, health and crime outcomes involves not only finding ways to improve the health and education systems *per se*, but also finding much more effective ways of dealing with welfare, particularly sole parents.

So, upfront, I would do something to try and fix the welfare system. Our taxes are too high in New Zealand because spending on health has been rising by around 6% p.a. and education by 3%. School choice and reforms like that will help, but unless we do something fundamental about welfare we are not going to reduce the demands on health and education. Education expenditure should not be increasing at all in real terms. This is an area where there are huge productivity gains to be made. Health expenditure should only increase by 1% or 2% a year. While there were some real improvements in productivity in the mid-1990s, we are now going backwards in health.

**SW:** The social policy establishment in Australia strongly resist any linkage between family structure and, say, poor educational outcomes. They argue that any attempt to make such a link is just a callous strategy to stigmatise sole parent or ‘alternative’ families so that the government can reduce

benefits, save money and offer tax cuts to the well-off. I suspect it's a similar story in New Zealand. How would you counter this cynicism?

**RD:** The Left continues to promote a system that ends up making hundreds of thousands of New Zealanders and Australians dependent on the state. Dependency is the worst thing you can do to any individual. The Left claim to care, but their answer is just to throw more money at the problems. If 'tax and spend' was the answer, the problems would have been solved a long time ago.

Spending has not improved the performance of New Zealand's public services. Over the last ten years, health spending has increased by 117% but people are still dying on the waiting list. Over the same period, education spending has increased by 65% but 20% of children leave school functionally illiterate and a further 20% have qualifications which make them unsuitable to undertake little more than manual work. Welfare spending has also increased by 50%. The number of people on the invalid benefit has doubled while the number on the sickness benefit has risen by a third. Over 400,000 New Zealanders of working age rely each week on a benefit for their income. If spending was going to solve the problem, it already would have.

### Is there a better way?

**SW:** So what do you propose instead?

**RD:** Government spending on welfare, retirement income, health and education has now reached \$8,000 per New Zealander and \$24,000 per household per year. I propose switching existing

spending from government monopolies and putting it into the hands of consumers.

Take somebody married with three children and bringing home \$1,000 a week. After tax, they end up with around \$39,000 a year. That's a higher than average income in New Zealand. After that family pay for their rent or mortgage, their car, their food, their power, their telephone, and unforeseen expenses and other extras, they simply don't see how they have enough money to send their children to private schools, take out a health policy, or save for retirement. The contract that the Left has is that they provide education, health, welfare and so on. This group of people have no option but to take it. Education is free but it's lousy. Health is free but you get put on a waiting list and could die while on it. Welfare is free but it locks you into dependency on the whim of politicians because if you go back to work you lose it, and if you marry someone who works, you lose it, and so on. Retirement is free but it's subsistence level only.

So what should we do? My view is that school choice, privatisation of health or risk management (accident, sickness and unemployment) and so on are difficult to do on a one-by-one basis. It is better to package it, and to package it in a way that ordinary people understand. The one thing that average working people understand is their own pay packet.

I propose giving people a tax credit. For example, a three-child family would receive a tax credit of \$26,000. They then take responsibility for their children's education, buying health and risk management (unemployment, sickness and accident) policies and saving for retirement. As a result of what I propose, every taxpayer would get a tax reduction. Most single taxpayers would still find themselves paying some tax, but they would be paying less, while families with more than two children would end up with a tax credit. What would change is that they would be spending their own money, or the money that is currently spent by the government on their behalf.

**SW:** In other words, what you are proposing is to fund demand-side reform, not just supply-side reform like getting government out of education and health provision?

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Roger Douglas talks with Susan Windybank

**RD:** Yes, but principally by giving people back their own money. There are a lot of groups trying to advocate reform but I think this sometimes goes over the top of people's heads. School choice and so on may appeal to 5%-6% of the electorate, but it won't appeal to most because they can't see how they can afford it. That is why I'd take a pay packet approach. If people don't understand anything else, they can always understand their pay. A family of five can see that they've got \$26,000 more and that they are responsible for health, education, insurance against risk and putting something away. They've got a chance of making a judgement and taking control of their lives.

The principle that the centre Right should be talking about is that if you work, you won't be poor. The aim is to improve the lot of the hardworking poor over the person on benefits and to give them some hope. If you hold out the hope that they will have some money in the bank, but more particularly they will have some control over their life as well, then you have a chance of getting through.

**SW:** Isn't this just another version of the old Negative Income Tax or citizen's wage?

**RD:** Not for single people, most of whom would still pay some tax. For families with two children or more, it will be a form of Negative Income Tax because the cost of education is included in the tax credit.

What is different about what I am advocating is in the area of superannuation. Whereas in Australia

you have a compulsory system where the employer pays, I propose giving everyone between 18 and 65 years of age a tax credit of \$4,000 (inflation adjusted), which would go into an individual savings account. People would draw on that money to buy, for instance, university education, or to provide themselves with an income if they become unemployed, sick, or could not work because of an accident. The idea is that people get the sense that they are spending their own money.

**SW:** You mentioned the increase in single mothers before. Do your proposals address why this is happening and what can be done to prevent it?

**RD:** Yes, that's exactly what I'm trying to do. Whenever you've got a problem, you've got to look at the solution and the transition. We've got 190,000 children in single parent families. Some 20% of those families are dysfunctional. That's the problem. The solution is to make it less attractive to become a single mother as a career choice. But to be tough, you have to appear to be generous, and \$4,000 a year saved over, say, 47 years at 5% real comes to close to a million dollars. That's the prospect you're holding out to people who work. On the other hand, those on welfare will not get their benefits but will draw down on their own \$4,000 entitlement for superannuation and the father's \$4,000 before they receive anything from the state in that year. In other words, the state isn't going to pay much directly and if people go back into the workforce they keep it.

The transition will take time. But the big incentive is that if people actually work they can become relatively wealthy rather than poor. That's the philosophy behind this.

### From theory to practice

**SW:** How would you fund it?

**RD:** As far as the tax credit goes, the basic principle is that you are giving people back their own money—that is, what the government already spends on them for education, health and welfare. No extra money is involved. The big, additional money is in the cost of superannuation. That would cost \$9 billion gross. This could be funded through a combination of the current \$3 billion surplus, interest savings from privatisation, savings from reduced welfare dependency, as a result of changes in incentives and the privatisation of sickness, accident and health,

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and reduced spending on public services, including the \$4,000 clawback from tertiary students and welfare beneficiaries. At the end of seven years we could then reach a flat tax rate of 15% per year, including corporate tax.

**SW:** It sounds similar to the provident fund in Singapore, but the government there was able to compel people to take the package. Compulsory individual superannuation along the lines of what you are proposing was rejected in a referendum in NZ just a few years ago.

**RD:** It is true that the system relies on compulsion. People often object to compulsion and argue that people must have freedom and take personal responsibility. But as a practical politician I know that in a civilised country like New Zealand we would not seriously let a person starve or die in the gutter because they had not saved during their working life or purchased a health policy. The problem is that if you don't compel people to save, you end up with welfare again. The objective of my proposals is to (1) privatise over time the \$9 billion the government currently spends on the retired; and (2) reduce the number of people on welfare by at least 50% or 200,000 people over a five year period.

**SW:** Another difference is that Singapore is a country where welfare is considered a private, family responsibility. Aren't you assuming that New Zealanders want personal control and active choice when the reality is that dependency on government and an entitlement mentality is deeply entrenched? Or to put it another way, to get where you want to go with your proposals, you wouldn't start from where you are in New Zealand.

**RD:** At the end of the day, the aim is to change incentives. At the moment, if someone is unemployed or a single mother, they look to the government to pay them. So the incentive is to stay where you are. I am trying to create an incentive whereby if you are working and stop working, the money you get while you are not working comes out of your pocket, or what would otherwise be yours if you worked, not from the state.

It also encourages a high degree of personal responsibility, because I would insist on catastrophic cover for health, meaning you have to pay your own healthcare costs up to 5% of your income in any one year. In the case of unemployment and sickness and accident cover, you would have to insure for what the government would pay you anyway beyond the first six months, making the person responsible for the first six months of cover. This would be the minimum level of cover required. Individuals would be free to insure for a higher amount if they so desire. And in terms of education, you have to send your children to school. That's

the law now anyway so there's already compulsion in that area.

The big change is the incentive to get off welfare. If you go out to work, you're going to have a pot of money in retirement, but if you don't the onus is on you and a minimum safety net will be your only cover.

### Is it politically possible?

**SW:** Do you think the New Zealand electorate has the stomach for more radical reforms?

**RD:** New Zealand has changed a great deal over the past 65 years since the welfare state was designed, yet public services have not. An increasingly consumer-orientated society is ready for change, but the public has never been presented with an alternative to nationalised welfare, healthcare and schools, or offered real choice.

The present system is what the Left offer. It's a package. After you've paid your taxes, they say, we'll pay for your children's education, health, money in retirement, and if you're sick or have an accident, we'll look after you. The centre Right doesn't have a package like that. That's why I think you have to do it by way of a package because even if you win the argument on school choice, people will still look to the government if they become unemployed or sick. The centre Right has to offer a package that is the equivalent and better in the areas of education, health, welfare and retirement.

The big problem is believability. I'm not sure how to overcome it. When we formed ACT and promoted zero tax, I commissioned several prominent accounting and financial firms to sign off that all the numbers added up, and people still didn't believe it. It was too good to be true from their perspective. But I think this package is more saleable because it deals directly with the welfare system, looks after the hardworking poor, and creates a new breed of entrepreneurs—for example, teachers who own their own schools. You'll get more teachers on your side if they can see how to make a buck out of it while making the system better for children than it currently is.

For the Centre Right to win government in the future they must appeal across into the Labour vote, the Green vote, and the New Zealand First vote. And they'll never do that, in my opinion, until they come up with something that demonstrates to people that in the areas of health, education, welfare and retirement they have a package that is better than what the Left is offering.

**SW:** But can the kind of government that would be required to put your ideas into practice ever get elected in New Zealand?

**RD:** In New Zealand the natural party of government has become the Labour party, which wasn't the case in the past. This has been reinforced by the changes to the voting system. For the centre Right to win government in the future they must appeal across into the Labour vote, the Green vote, and the New Zealand First vote. And they'll never do that, in my opinion, until they come up with something that demonstrates to people that in the areas of health, education, welfare and retirement they have a package that is better than what the Left is offering. Now it's not hard to come up with a package; the difficulty is in marketing it. However it doesn't need to be marketed to everybody. All you need to do is win 10% of the Left vote to get a centre Right government into office. I don't see how they're going to get elected otherwise, unless there is a crisis—

**SW:** —which may well happen! Let me end on that cliffhanger by thanking you for this interview.

