

Two Steps Forward, One Step Back

New Zealand's Shaky Economic Constitution

Wolfgang Kasper

The re-regulation of labour by New Zealand's minority government not only reflects what Australia's Labor opposition is contemplating, but also demonstrates how easily the economic reforms of the 1980s and 1990s can be overturned.

In August 2000, New Zealand's left minority coalition will abolish the Employment Contracts Act. In conjunction with other interventionist legislation, this marks a far-reaching revision of the country's current liberal 'economic constitution', i.e. the fundamental rules that determine how people coordinate their activities (Kasper 2000: 20-25).

Seen in isolation, most of the legislative changes the New Zealand government has introduced since the election in late 1999 seem small. But taken together these measures are not simply minor technical corrections of the existing economic order. They amount to a reactionary overturn of New Zealand's much-acclaimed liberal economic constitution.

The Clark-Anderton government's policy stance reveals a fundamental scepticism about the merits of spontaneous individual initiative and the coordination of free people and firms by market competition within the rule of law. It also signals a belief that a stronger role for the state and more top-down collective coordination can achieve better outcomes while avoiding deleterious side effects. Experience shows that this belief is often mistaken.

That the current government's moves are but a correction of New Zealand's liberal economic order may seem plausible to those who take New Zealand's pre-1984 regime as the norm, or who consider the social democratic, sclerotic European bloc as an appropriate yardstick. But New Zealand is a wide-open economy in the Asia Pacific. New Zealanders compete on their own with producers who enjoy an increasingly dynamic Anglo-Saxon form of

capitalism that attracts internationally mobile capital, enterprises and highly skilled people. Many New Zealanders are also in direct competition with Singaporeans, Taiwanese and others in open competitive Asian countries.

The New Zealand combination of openness and selective regulation at home will certainly give students of political economy valuable empirical insights into the limits of the 'primacy of politics' over economic life under globalisation. This is an important, almost moral, issue. Some find it scandalous that international capital markets now impose the daily constraints of globalisation on democratically elected governments; others welcome the new discipline because they know that parliamentarians, once elected, act opportunistically to ensure their re-election and that the new openness empowers citizens. The present tinkering with constitutional rules in New Zealand therefore promises to shape up as an important litmus test for establishing what scope a small open economy still has for detailed regulatory interventions. We will be able to learn what the economic feedback is after a sovereign change from a liberal to a more interventionist-collectivist economic constitution.

Wolfgang Kasper is Senior Fellow at The Centre for Independent Studies (CIS). This is an extract from his recently released policy monograph *Gambles with the Economic Constitution: The Re-Regulation of Labour in New Zealand*, available from CIS.

New Zealand's liberal economic constitution

Between 1984 and 1994, successive New Zealand governments created what was widely admired as the freest and most straightforward economic constitution in any OECD country (Brash 1996; Evans et al. 1996; Silverstone et al. 1996; Kasper 1996a, ch. 1). New Zealand now has the most open economy of any mature industrial country, a freely floating exchange rate, and deregulated domestic markets for goods, services and finance. Capital and labour markets were freed from most government controls other than to protect safety, health and the environment. Most infrastructure services are now offered on a competitive basis. This makes for low input costs to industry and citizens, and boosts the international competitiveness of NZ-based exporters.

The three pillars on which the new capitalist economic constitution rests are the Reserve Bank Act of 1989, the Employment Contracts Act of 1991, and the Fiscal Responsibility Act of 1994. Two of these three pillars are now under threat of reactionary revision. As of spring 2000, the Employment Contracts Act will be abolished, while the Reserve Bank Act is under official review.

Clearly, the liberal economic order is not deeply entrenched. As far back as 1994, the much-admired reformatory zeal began to flag. Successive conservative-led governments demonstrated by their very behaviour and the opportunistic breach of election promises that they no longer believed in free markets, self-reliance and minimal government. Detailed outcome-specific regulations proliferated again. Opponents of liberalisation, who had lost every argument about the new economic order, understood the interdependence of the economic and political rules, and managed to have key political institutions overturned in favour of a new electoral regime—the Mixed Member Proportional (MMP) system—which gives voters less direct control over politicians. This eventually brought a collectivist majority back to power, and with it the opportunity to overturn the free market regime.

On the principles of institutional design and reform

To understand the costs these zig-zag changes are imposing on growth, job creation and stability, one needs a basic understanding of the principles of institutional economics (see Kasper 1998; Kasper-Streit 1998).

It is now increasingly accepted that the formation of human and physical capital, resource mobilisation from domestic and overseas sources, rapid technical innovation, and structural adaptability to new conditions and opportunities are only the proximate causes of economic growth. They depend in turn on deeper causes, namely the underlying rules that motivate and coordinate human action and, in particular, those overarching rules that make up the economic constitution (Kasper-Streit 1998, ch. 1).

Much coordination is based on internal institutions—ethical norms, work practices, conventions and customs—which evolve from human experience. Rule breaches tend to be sanctioned spontaneously, informally and cheaply. These internal rules contrast with external institutions, such as legislation and administrative regulations, which are designed and imposed on society by political agents and are enforced by formal means.

Enforcement relies on coercion, and this tends to cause high agency and compliance costs. Effective coordination therefore requires that the external rules do not replace internal rules, but only support and complement them (Kasper 1998, ch. 3 and 6).

If a community's internal and external institutions form a cohesive whole, they order economic, civil and political action effectively. People then cooperate and innovate with confidence despite the cognitive limitations from which we all suffer. A trust-based economy that is founded on effective institutions enjoys low transaction costs and will grow. By contrast, people who are subjected to complicated, arbitrary and outcome-specific interventions can cooperate only on the basis of personal relations—a more costly way of coordinating activity.

When the rules are hard to know or poorly enforced, people become confused and often lack the motivation to explore possible improvements. Entrepreneurial energies are then diverted from cultivating commercial and/or technical prowess and wealth creation into sports, lobbying, redistribution, war and other non-productive pursuits (Baumol 1990).

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The central importance of institutions to prosperity, security, social peace and justice is often overlooked by academics and regulators. They forget all too easily that the complexity of modern economic life requires simple, consistent and stable rules that give citizens freedom and self-responsibility (Epstein 1995). Rule systems also need to be universal if they are to be effective, a principle now widely accepted in law and economics (Leoni 1962). People can only understand and obey rules when they are general and abstract, when they remain stable and are therefore perceived as certain, and when existing rules are open, in the sense that present rules will apply to unknown future circumstances (Kasper 1998: 51-56).

Individuals who want to invest their time and money in commercial, technical or organisational innovations for the sake of hoped-for but uncertain future profits are easily overtaxed when the rules keep changing or when the legislators write rule books that are too complicated.¹ Individuals are simply unable to assess all the consequences of institutional change and fear being surprised by unexpected deleterious side effects. In a complex and dynamic economy, changes in the tax regime or in labour market regulations therefore work as major destroyers of confidence and as obstacles to innovation and job creation.

New Zealand's inconsistent approach to the economic ground rules of business and, more recently, the parliament's increasingly interventionist proclivity, detract greatly from the principle of universality. This leads me to predict losses in the effectiveness of coordinating work and business. In the medium term, the consequences will be reflected in what economists call poor 'third factor growth', namely relatively poor returns on capital and labour. I will not be surprised if the new interventionist approach halves the natural growth rate and doubles unemployment.

Stable rules of universal quality matter in particular to the modern knowledge industries, which thrive on continuing innovation and which are exposed to fickle international competition. In the knowledge industries and the service enterprises of the 'new economy', a very large share of all costs are transaction costs, which depend critically on simple and expedient rules (Kasper 1998, ch. 2, 3; Kasper-Streit 1998: 95-98, 125-129, 221-228). Whereas traditional agriculture and manufacturing, with their low-skill production routines, technological rigidities and mass-product markets provided a degree of inherent continuity, the rapidly growing 'new economy' depends more on stable rules and the predictable, constitutionally-

bound evolution of those rules. Policymakers whose ideology and mentality were shaped by an earlier agricultural or industrial age and who believe they can change the rules with gay abandon, therefore frustrate the new knowledge and innovation economy.

Simple, free and stable institutions—a community's 'constitutional capital'—must nowadays be considered more important than physical capital, natural resources or practical skills. Most New Zealand legislators seem to have difficulties in understanding this fundamental fact.

Institutional leads and lags

This theory of institutional design and its psychological underpinnings can help us understand why the economic reforms of 1984-1994 were resented by some and why the overturning of the competitive regime now appears attractive to many.

The first Labour-led wave of economically liberal reforms in 1984-85 was inspired and led by Finance Minister Roger Douglas. These reforms created urgently needed relief from the economic and financial crisis in the wake of the Muldoon government's 'Think Big' spending spree. But they introduced major institutional inconsistencies. Labour markets and social welfare, for instance, were largely exempted from reform, and the Labour Party had some inhibitions about outright privatisation. New Zealand's economic institutions were soon out of step with each other; liberal sub-orders clashed with the interventionist residues of an earlier era. Rising unemployment, budget deficits and a weak currency were the consequence.

After the Labour government lost its way, the National Party government, elected in 1991, obeyed the maxim of institutional consistency better. They pulled labour markets in line with a liberalised competitive economy, introduced further public sector and budget reforms and undertook some steps to address the growing dependency on public welfare. Nonetheless, the maxim of institutional consistency was not widely understood by parliament. It was obviously deemed too difficult to haul some hard-core leftovers from the old era, such as welfare, into line with the new economic constitution (Kasper 1996b).

It is important to note that the changes to the country's economic constitution were designed and imposed by a small policy elite. The



¹ The Employment Relations Bill that the government put before the New Zealand parliament is some 200 pages long and is crammed with much detail to prescribe and enforce specific outcomes.

two waves of reform imposed from above did not necessarily harmonise with the internal institutions of society, i.e. the morals, customs, conventions and work practices. After eight decades of state paternalism, it takes time for everyone to learn the *modus operandi* under a free market regime and adjust the internal rules accordingly. As in Eastern Europe since the fall of the Wall, the internal institutions of New Zealand society evolved sluggishly. In particular, the attitudes to welfare dependency were slow to change among the elderly. As in Eastern Europe, a political backlash set in, once people realised that a competitive order obligates everyone to shoulder the transaction costs of competing. This paved the way for the present reaction, which has been once again designed and imposed by a small political and union elite.

The return in the early 2000s to a more collectivist order will not be cost-free. Any rule change inflicts adjustment costs. Going in one direction and then back again will destroy trust and confidence. Many New Zealanders—the young, the enterprising and new firms in particular—have in the meantime adjusted to the competitive ground rules and have built this into their expectations. They will now be disoriented by the parliament's reactionary turn. Some will give up. Others will move elsewhere, as a steep rise in emigration since the elections already indicates.

A lacking constitutional consensus

Steadying and confidence-inspiring checks and balances in the political constitution usually prevent disorienting changes to the economic rulebook. Overriding constitutional rules cannot be changed easily by simple parliamentary majorities and are typically enshrined in fundamental human rights or constitutional preambles. Bicameral parliaments and the requirement of big majorities for fundamental, constitutional-type changes are other devices that safeguard continuity and cohesion in the rule system (Kasper-Streit 1998: 134-142, see also Ratnapala 1999-2000).

New Zealand, however, has few such stabilising safeguards. It does not have a written political constitution. In its unicameral parliamentary system, simple majorities—or rather majorities in decisive and selectively staffed committees of parliament—can swiftly impose fundamental changes in the constitutional ground rules

governing economic conduct. Maybe this is why they call the country 'the Shaky Islands'!

The lack of constitutional anchors enabled the Lange-Douglas and Bolger-Richardson administrations to

overturn the old interventionist-welfarist rule set with surprising ease. Now it enables another majority—or rather a minority coalition—to overturn the liberal economic constitution.

In an unanchored institutional framework, there is little need to explain changes and win allies among the wider public. This saves on the transaction costs of reform, but hampers fundamental attitude changes and public recognition of the

importance of external rule changes. Over time, basic attitudes will of course adapt and new internal rules will be tried out to fit in with the changed external rules.

During these transitions, inconsistencies between rule sets and between slow and fast learners impose friction and pain. The fairly unstable array of partly contradictory internal and external rules was the underlying reason for the relatively poor initial growth response when world-class liberalisation was imposed from above (Kasper 1996c). New Zealanders should know by now that tinkering with the economic constitution inflicts high adjustment costs. Even if the rules promote economic freedom, it takes time until the pay-offs become universal. But they then last for a long time. Ludwig Erhard's liberal reform in post-war Germany paid off into the 1970s, and the Reagan and Thatcher reforms of the early 1980s are still adding vigour to Anglo-Saxon growth into the early 2000s. Alas, in the case of New Zealand, the turnaround of 2000 will deny citizens the full long-term payoff for the investments in a more market-oriented set of institutions.

A matter of basic philosophy

Ultimately, New Zealand's zig-zag approach to the institutional foundations of economic life has a lot to do with fundamental disagreements about ideology. In many countries, these disagreements have now been resolved in the light of experience. For example, British Labour now embraces a slightly modified Thatcherite approach to economic and social policy, disguising the fact by fuzzy talk about a 'Third Way'. And in the US, the two major parties are committed to an individualistic philosophy and market-based institutions.

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Despite the rhetoric to the contrary, the Clark-Anderton government still carries much old-fashioned intellectual baggage concerning anti-market collectivism, as the policy initiatives of 1999-2000 indicate (Kasper 2000: 9-15). New Labour has little in common with the Labour party of the 1980s, when Roger Douglas and Richard Prebble implemented reforms because collectivist *dirigisme* had failed. One cannot help but conclude that the deep rift among ideologies, which developed in the 19th century and which has shaped much of the 20th century, has not yet been overcome in New Zealand.

One ideological approach to governance is based on trust among responsible self-reliant individuals, who interact in civil society as equals, and do so freely and spontaneously. Private actions are then guided predominantly by the internal institutions of society and the disciplining force of free competition, but there is also reliance on private law. In such an institutional system, governments act only as the ultimate guarantors of trust and security: they protect the key rules, but abstain from engineering specific outcomes.

The alternative concept of society and governance is to rely much more heavily on hierarchical relationships and prescriptive, top-down coordination by the visible hand of government. This collectivist approach basically distrusts the disciplining force of spontaneous civil interaction and competition in markets and introduces complicated public law elements into many private interactions.

The present re-regulation of labour is clearly based on a rejection of the individualist approach. It aims to shift many concerns of normal private interaction from the sphere of private law, trust-based interaction and civil society to the sphere of coercive public law, relation-based interaction and hierarchical politicised society.

In individualist orders, the familiar processes of private law sort out the occasional unavoidable conflict that arises among citizens. Private litigation is among equals; it is constrained by considerations of private risk and private cost, as well as the realisation that the two parties will still have to do business with each other later. In collectivist orders, legislators usurp matters of private interaction and convert them to concerns of public or quasi-public law, as in New Zealand's workplace relations now. Yet this can easily end up in a muddled and cumbersome mix of responsibilities. The level of intervention, litigation and arbitration rises; transaction costs go up. One reason for

this is that intervening third parties—the arbitrators, the inspectors, union negotiators, and the commissars—have incentives to postpone conflict resolution. For them, it is profitable to spin out conflicts through formal arbitration or litigation. The verdict of the history of the 20th century is that this approach does not work well when applied to complex and changing circumstances, as for example the ordering of a nation's diverse labour markets.

The main reason why reliance on top-down external institutions is advocated despite their stultifying effects is rent seeking. Interventionism allocates power and income to an influential 'political class' of regulators and guardians who believe that ordinary citizens cannot be trusted to know what is good for them. When the political class regulates normal human interaction, they also find it easier to extract 'tribute' (protection money, compulsory membership fees, taxes and the like). The made order also enables them to allot material privileges (rents) to well-connected groups, which in turn perpetuate the political power of the controllers (Olson 1982). Under New Zealand's new labour regime, workplace relations will be conducted like a broken-down marriage where the partners communicate only through divorce lawyers. The winners will then be the mediators, the union

officials, Labour Department bureaucrats, lawyers and other third-party intermediaries. The losers will be the workers and the employers.

From a spontaneous to an imposed order

Those who comprehend the central importance of free and stable institutions to prosperity, justice and freedom are watching the destruction of 'constitutional capital' by the present government in disbelief. Do New Zealand voters really want a return to *de facto* union monopolies, copious striking and shop-steward meddling on the shop floor? Do they really believe that the grab of power by the intermediating political elites will improve their lives?

The legislation amounts to regulation of the unions by the unions for the unions. The new institutions matter, because they come with a hard bite. The legislature is decreeing numerous sanctions, injunctions, compliance orders, penalties, class actions, and damages claims. It is likely that employers will try to circumvent costly new workplace regulations by searching for creative and legally sustainable counter-strategies. But this is not a cost-free exercise. The unions and government agencies will

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probably contest some of these manoeuvres—a source of legal uncertainty and higher transaction costs for those providing jobs in years to come.

It is the government's declared hope to 'promote an increase in workplace productivity through improved workplace relationships' (Lingard 2000: 4). This hope seems misplaced. The complexity of the new rule system, the coercive intervention of government agencies and unions with state-sanctioned privileges, and the regulatory formalism of the Employment Relations legislation will add greatly to the transaction and compliance costs of employing people. Many natural and evolutionary productivity improvements will no longer seem worthwhile. This will be mainly at the expense of ordinary workers and those who have not yet found access to work.

Big corporations will of course be able to build up their legal and industrial relations departments, but this will affect their asset values over the long term and hence the wealth of New Zealand shareholders. Small firms and start-up enterprises will be affected more directly. They will be diverted from concentrating on commercial and production tasks, and will frequently make the rational choice to remain ignorant of the rules that now complicate job creation. The tacit assumption of administrators and academics is that 'regulatees' happily and eagerly learn new rules, whatever they are. This is wrong. The usual limits of human cognition and the many pressures of daily business life in small firms mean that most of them simply have to operate in 'rational ignorance' of the rules. They will resent the nagging feeling that they are not abiding by the rules. Given the coercive and employer-annoying nature of many of the new industrial relations provisions, they will also be running high risks.

This new constitutional inconsistency is also confusing for investors. It is one matter to slow reforms to a snail's pace but still proceed in the same direction (as the New Zealand parliament did in the late 1990s). It is quite another to reverse the direction of institutional change. If a community switches from traffic rules that mandate driving on the right-hand side of the road to the left, accidents are bound to happen, the flow of traffic is bound to slow down and driving is less fun.

Such constitutional stop-go was the hallmark of economic policy in the United Kingdom during the late 1940s, 1950s and 1960s. It was rightly blamed for the country's subsequent moral and economic decline, and the lesson has been learned in the UK. Unfortunately, the New Zealand electorate and legislature seem totally ignorant of this important lesson of history.

Conclusion

The economic institutions that underpin economic success stories resemble each other, but economic failures differ widely. This is an application of the *Anna Karenina principle*.² New Zealand policymakers struggled to shape the constitutional conditions for success in the open global economy, and work practices, popular belief systems and attitudes have gradually, though imperfectly, begun to fall into line. Sadly, the sharp left turn of 2000 is now disrupting this process and is paving the way for New Zealand's very own path to economic underperformance. ■

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² This concept of social science is inspired by Tolstoy's opening sentence in *Anna Karenina* 'Happy families are all alike; every unhappy family is unhappy in its own way.'