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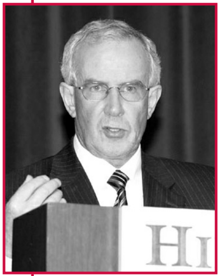

Rolling Back the Government: Lessons from New Zealand

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MAURICE P. MCTIGUE is a distinguished visiting scholar at the Mercatus Center at George Mason University, where he directs the government accountability project. Previously, he was a member of the New Zealand Parliament and New Zealand's ambassador to Canada, and was closely involved in New Zealand's deregulation of labor markets, deregulation of the transportation industry, and restructuring of the fishing industry through the creation of conservation incentives. He also served as Minister of Employment, Minister of State Owned Enterprises, Minister of Railways, Minister of Works and Development, Minister of Labour and Minister of Immigration. Among his many honors, Mr. McTigue is a recipient of the Queen's Service Order, bestowed by Queen Elizabeth II in a ceremony at Buckingham Palace. In the U.S., he was recently appointed to the Office of Personnel Management Senior Review Committee, formed to make recommendations for human resources systems at the Department of Homeland Security. He also sits on the Performance Management Advisory Committee for the Commonwealth of Virginia.

The following is adapted from a lecture delivered on February 11, 2004, on the Hillsdale campus, during a five-day seminar on "The Conditions of Free-Market Capitalism," co-sponsored by the Center for Constructive Alternatives and the Ludwig Von Mises Lecture Series.

If we look back through history, growth in government has been a modern phenomenon. Beginning in the 1850s and lasting until the 1920s or '30s, the government's share of GDP in most of the world's industrialized economies was about six percent. From that period onwards – and particularly from the 1950s onwards – we've seen a massive explosion in government share of GDP, in some places as much as 35-45 percent. (In the case of Sweden, of course, it reached 65 percent, and Sweden nearly self-destructed as a result. It is now starting to dismantle some of its social programs to remain economically viable.) Can this situation be halted or even rolled back? My view, based upon personal experience, is that the answer is "yes." But you need to achieve high levels of transparency and you need to ensure that there are consequences for bad decisions – and these are not easy things to do.

What we're seeing around the world at the moment is what I would call a silent revolution, reflected in a change in how people view government accountability. The old idea of accountability was based on ensuring that government spent money in accordance with appropriations. The new accountability is based on asking, "What did we get in public benefits as a result of the expenditure of money?" This is a question that has always been asked in business, but has not been the norm for governments. And those governments today that are struggling valiantly with this question are showing quite extraordinary results. This was certainly the basis of quite successful reform in my own country of New Zealand.

New Zealand's per capita income in the period prior to the late 1950s was right around number three in the world, behind the United States and Canada. But by 1984, its per capita income had sunk to 27th in the world, alongside Portugal and Turkey. Not only that, but our unemployment rate was 11.6 percent, we'd had 23 successive years of deficits (sometimes ranging as high as 40 percent of GDP), our debt had grown to 65 percent of GDP and our credit ratings were continually being downgraded. Government spending was a full 44 percent of GDP, investment capital was exiting in huge quantities, and government controls and micromanagement were pervasive at every level of the economy. We had foreign exchange controls that meant I couldn't buy a subscription to *The Economist* magazine without the permission of the Minister of Finance. I couldn't buy shares in a foreign company without surrendering my citizenship. There were price controls on all goods and services and on all shops and on all service industries. There were wage controls and wage freezes. I couldn't pay my employees more – or pay them bonuses – if I wanted to. There were import controls on the goods that I could bring into the country. There were massive levels of subsidies on industries in order to keep them viable. Young people were leaving in droves.

Spending and Taxes

When a reform government was elected in 1984, it identified three problems: too much spending, too much taxing and too much government. The question was how to cut spending and taxes and diminish government's role in the economy. Well, the first thing you have to do in this situation is to figure out what you're getting for dollars spent. Towards this end, we implemented a new policy whereby money wouldn't simply be allocated to government agencies; instead, there would be a purchase contract with the senior executives of those agencies that clearly delineated what was expected in return for the money. Those who headed up those agencies were now chosen on the basis of a worldwide search and received term contracts – five years with a possible extension of another three years. The only grounds for their removal was non-performance, so a newly-elected government couldn't simply throw them out as had happened with civil servants under the old system. And of course, with those kinds of incentives, agency heads – like CEOs in the private sector – made certain that the next tier of people had very clear objectives that *they* were expected to achieve as well.

The first purchase that we made from every agency was policy advice. That policy advice was meant to produce a vigorous debate between the government and the agency heads about how to achieve goals like reducing hunger and homelessness. This didn't mean, by the way, how government could feed or house more people – that's not important. What's important is the extent to which hunger and homelessness are actually reduced. In other words, we made it clear that what's important is not how many people you support on welfare, but how many people you get off welfare and into independent living.

As we started to work through this process, we also asked some fundamental questions of the agencies. The first question was, "What are you doing?" The second question was, "What *should* you be doing?" Based on the answers, we then said, "Eliminate what you shouldn't be doing" – that is, if you are doing something that clearly is not a responsibility of the government, stop doing it. Then we asked the final question: "Who should be paying – the taxpayer, the user, the consumer, or the industry?" We asked this because, in many instances, the taxpayers were subsidizing things that did not benefit them. And if you take the cost of services away from actual consumers and users, you promote overuse and devalue whatever it is that you're doing.

When we started this process with the Department of Transportation, it had 5,600 employees. When we finished, it had 53. When we started with the Forest Service, it had 17,000 employees. When we finished, it had 17. When we applied it to the Ministry of Works, it had 28,000 employees. I used to be Minister of Works, and I finished up being the *only* employee. In the latter case, most of what the department did was construction and engineering, and there are plenty of people who can do that without government involvement. And if you say to me, "But you killed all those jobs!" – well, that's just not true. The *government* stopped employing people in those jobs, but the need for the jobs didn't disappear. I visited some of the forestry workers some months after they'd lost their government jobs, and they were quite happy. They told me that they were now earning about three times what they used to earn – on top of which, they were surprised to learn that they could do about 60 percent more than they used to! The same lesson applies to the other jobs I mentioned.

Some of the things that government was doing simply didn't belong in the government. So we sold off telecommunications, airlines, irrigation schemes, computing services, government printing offices, insurance companies, banks, securities, mortgages, railways, bus services, hotels, shipping lines, agricultural advisory services, etc. In the main, when we sold those things off, their productivity went up and the cost of their services went down, translating into major gains to the economy. Furthermore, we decided that other agencies should be run as profit-making and tax-paying enterprises by government. For instance, the air traffic control system was made into a stand-alone company, given instructions that it had to make an acceptable rate of return and pay taxes, and told that it couldn't get any investment capital from its owner (the government). We did that with about 35 agencies. Together, these used to cost us about one billion dollars per year; now they *produced* about one billion dollars per year in revenues and taxes.

We achieved an overall reduction in the size of government, measured by employees, of 66 percent. The government's share of GDP dropped from 44 to 27 percent. We were now running surpluses, and we established a policy *never* to leave dollars on the table: we knew that if we didn't get rid of this money, some clown would spend it. So we used most of the surplus to pay off debt, and debt went from 63 percent down to 17 percent of GDP. We used the remainder of the surplus each year for tax relief. We reduced income tax rates by half and eliminated incidental taxes. As a result of these policies, revenue *increased* by 20 percent. Yes, Ronald Reagan was right: lower tax rates do produce more revenue.

Subsidies, Education, and Competitiveness

What about invasive government in the form of subsidies? First, we need to recognize that the main problem with subsidies is that they make people dependent; and when you make people dependent, they lose their innovation and their creativity and become even *more* dependent.

Let me give you an example: By 1984, New Zealand sheep farming was receiving about 44 percent of its income from government subsidies. Its major product was lamb, and lamb in the international marketplace was selling for about $12.50 (with the government providing another $12.50) per carcass. Well, we did away with all of the sheep farming subsidies within one year. And of course the sheep farmers were unhappy. But once they accepted the fact that the subsidies weren't coming back, they put together a team of people charged with figuring out how they could get $30 per lamb carcass. The team reported back that this would be difficult, but not impossible. It required producing an entirely different product, processing it in a different way and selling it in different markets. And within two years, by 1989, they had succeeded in converting their $12.50 product into something worth $30. By 1991, it was worth $42; by 1994 it was worth $74; and by 1999 it was worth $115. In other words, the New Zealand sheep industry went out into the marketplace and found people who would pay higher prices for their product. You can now go into the best restaurants in the U.S. and buy New Zealand lamb, and you'll be paying somewhere between $35 and $60 per pound.

Needless to say, as we took government support away from industry, it was widely predicted that there would be a massive exodus of people. But that didn't happen. To give you one example, we lost only about three-quarters of one percent of the farming enterprises – and these were people who shouldn't have been farming in the first place. In addition, some predicted a major move towards corporate as opposed to family farming. But we've seen exactly the reverse. Corporate farming moved out and family farming expanded, probably because families are prepared to work for less than corporations. In the end, it was the best thing that possibly could have happened. And it demonstrated that if you give people no choice but to be creative and innovative, they will find solutions.

New Zealand had an education system that was failing as well. It was failing about 30 percent of its children – especially those in our lower socio-economic areas. We had put more and more money into education for 20 years, and achieved worse and worse results.

It cost us twice as much to get a poorer result than we did 20 years previously with much less money. So we decided to rethink what we were doing here as well.

The first thing we did was to identify where the dollars were going that we were pouring into education. We hired international consultants (reported we didn't trust our own departments to do it), and they reported that for every dollar we were spending on education, 70 cents was being swallowed up by administration. Once we heard this, we immediately eliminated all of the Boards of Education in the country. Every single school came under the control of a board of trustees elected by the parents of the children at that school, and by nobody else. We gave schools a block of money based on the number of students that went to them, with no strings attached. At the same time, we told the parents that they had an absolute right to choose where their children would go to school. It is absolutely obnoxious to me that anybody would tell parents that they must send their children to a bad school. We converted 4,500 schools to this new system all on the same day.

Every single school came under the control of a board of trustees elected by the parents of the children at that school, and by nobody else. We gave schools a block of money based on the number of students that went to them, with no strings attached.

But we went even further: We made it possible for privately-owned schools to be funded in exactly the same way as publicly-owned schools, giving parents the ability to spend their education dollars wherever they chose. Again, everybody predicted that there would be a major exodus of students from the public to the private schools, because the private schools showed an academic advantage of 14 to 15 percent. It didn't happen, however, because the differential between schools disappeared in about 18-24 months. Why? Because all of a sudden teachers realized that if they lost their students, they would lose their funding; and if they lost their funding, they would lose their jobs. Eighty-five percent of our students went to public schools at the beginning of this process. That fell to about 84 percent over the first year or soof our reforms. But three years later, 87 percent of the students were going to public schools. More importantly, we moved from being about 14 or 15 percent *below* our international peers to being about 14 or 15 percent *above* our international peers in terms of educational attainment.

Now consider taxation and competitiveness: What many in the public sector today fail to recognize is that the challenge of competitiveness is worldwide. Capital and labor can move so freely and rapidly from place to place that the only way to stop business from leaving is to make certain that your business climate is better than anybody else's. Along these lines, there was a very interesting circumstance in Ireland just two years ago. The European Union, led by the French, was highly critical of Irish tax policy – particularly on corporations – because the Irish had reduced their tax on corporations from 48 percent to 12 percent and business was flooding into Ireland. The Europeans wanted to impose a penalty on Ireland in the form of a 17 percent corporate tax hike to bring them into line with other European countries. Needless to say, the Irish didn't buy that. The European community responded by saying that what the Irish were doing was unfair and uncompetitive. The Irish Minister of Finance agreed: He pointed out that Ireland was charging corporations 12 percent, while only charging its citizens only 10 percent. So Ireland reduced the tax rate to 10 percent for corporations as well. There's another one the French lost!

When we in New Zealand looked at our revenue gathering process, we found the system extremely complicated in a way that distorted business as well as private decisions. So we asked ourselves some questions: Was our tax system concerned with collecting rev-

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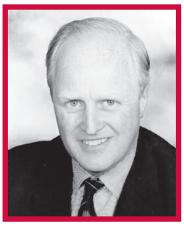

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enue? Was it concerned with collecting revenue and also delivering social services? Or was it concerned with collecting revenue, delivering social services and changing behavior, all three? We decided that the social services and behavioral components didn't have any place in a rational taxation system. So we resolved that we would have only two mechanisms for gathering revenue – a tax on income and a tax on consumption – and that we would simplify those mechanisms and lower the rates as much as we possibly could. We lowered the high income tax rate from 66 percent down to 33 percent, and set that flat rate for high-income earners. In addition, we brought the low end down from 38 to 19 percent, which became the flat rate for low-income earners. We then set a consumption tax rate of 10 percent and eliminated all other taxes – capital gains taxes, property taxes, etc. We carefully designed this system to produce exactly the same revenue as we were getting before, and presented it to the public as a zero sum game. But what actually happened was that we received 20 percent more revenue than before. Why? We hadn't allowed for the increase in voluntary compliance. If tax rates are low, taxpayers won't employ high priced lawyers and accountants to find loopholes. Indeed, every country that I've looked at in the world that has dramatically simplified and lowered its tax rates has ended up with more revenue, not less.

What about regulations? The regulatory power is customarily delegated to non-elected officials who then constrain the people's liberties with little or no accountability. These regulations are extremely difficult to eliminate once they are in place. But we found a way: We simply rewrote the statutes on which they were based. For instance, we rewrote the environmental laws, transforming them into the Resource Management Act – reducing a law that was 25 inches thick to 348 pages. We rewrote the tax code, all of the farm acts, and the occupational safety and health acts. To do this, we brought our brightest brains together and told them to pretend that there was no pre-existing law and that they should create for us the best possible environment for industry to thrive. We then marketed it in terms of what it would save in taxes. These new laws, in effect, repealed the old, which meant that all existing regulations died – the whole lot, every single one.

Thinking Differently About Government

What I have been discussing, really is simply a new way of thinkingabout government. Let me tell you how we solved our deer problem: Our country had no large indigenous animals until the English imported deer for hunting. These deer proceeded to escape into the wild and become obnoxious pests. We then spent 120 years trying to eliminate them, until one day someone suggested that we just let people farm them. So we told the farming community that they could catch and farm the deer, as long as they would keep them inside eight-foot high fences. And we haven't spent a dollar on deer eradication from that day onwards. Not one. And New Zealand now supplies 40 percent of the world market in venison. By applying simple common sense, we turned a liability into an asset.

Let me share with you one last story: The Department of Transportation came to us one day and said they needed to increase the fees for driver's licenses. When we asked why, they said that the cost of of relicensing wasn't being fully recovered at the current fee levels. Then we asked why we should be doing this sort of thing at all. The transportation people clearly thought that was a very stupid question: Everybody needs a driver's license, they said. I then pointed out that I received mine when I was fifteen and asked them: "What it is about re-licensing that in any way tests driver competency?" We gave them ten days to think this over. At one point they suggested to us that the police need drivers licenses for identification purposes. We responded that this was the purpose of an identity card, not a driver's license. Finally they admitted that they could think of no good reason for what they were doing – so we abolished the whole process! Now a driver's license lasts until a person is 74-years old, after which they must get an annual medical test to ensure they are still competent to drive. So not only did we not need new fees, we abolished a whole department. That's what I mean by thinking differently.

There are some great things happening along these lines in the United States today. You might not know it, but back in 1993 Congress passed a law called the Government Performance and Results Act. This law orders government departments to identify in a

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strategic plan what it is that they intend to achieve, and to report each year what they actually did achieve in terms of public benefits. Following on this, two years ago President Bush brought to the table something called the President's Management Agenda, which sifts through the information in these reports and decides how to respond. These mechanisms are promising if they are used properly.

Consider: There are currently 178 federal programs designed to help people back to work. They cost $8.4 billion, and 2.4 million people are employed as a result of them. But if we took the most effective three programs out of those 178 and put the $8.4 billion into them alone, the result would likely be that 14.7 million people would find jobs. The status quo costs America over eleven million jobs. The kind of new thinking I am talking about would build into the system a consequence for the administrator who is responsible for this failure of sound stewardship of taxpayer dollars. It is in the direction that the government wants to move.

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