

The Keys to Revving Up New Zealand's Economic Reform Engine

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Introduction

In the early 1980's, New Zealand's tightly regulated economy nearly collapsed. Poor monetary policy had produced large deficits, increasing public debt, and currency crisis in the Kiwi nation (Bale & Dale, 1998; Suppanz, 1998). Only dramatic policy changes could prevent complete economic meltdown. Those changes began in 1984, when New Zealanders voted the Labour party into power. Minister of Finance Roger Douglas ignited New Zealand's Great Capitalist Restoration with a reform package designed to stabilize the country's financial situation and root monetary policy in laissez-faire economic principles (Bale & Dale, 1998; McClintock, 1998).

Douglas' reforms came fast and hard. They shocked New Zealanders and shocked New Zealand's economy back to life. The era of reform continued in the early 1990's, when the National party rose to power. Minister of Finance Ruth Richardson implemented policy designed to revamp the labor market and increase state sector accountability (Atkinson, 1997; Cooper & Lenane, 1999). By the mid 1990's, New Zealand could no longer be called "the poorest of the advanced countries" (Atkinson, 1997, p. 43). The nation's economy was growing rapidly and was being praised as a model for capitalist reform. In fact, in 1996, *The Economist* magazine claimed New Zealand had "the best monetary- and fiscal-policy frameworks of any country in the world" ("Kiwis Turn," 1996, p. 19).

Just four years later, in 2000, *The Economist* called the results of New Zealand's reforms "disappointing" ("New Zealand's Economy," 2000, p. 69). The nation's economic growth had slowed, provoking a reanalysis of the Great Capitalist Restoration. What could New Zealand's reformers have done differently to improve and sustain their country's economic turnaround? A comparison to Ireland – a nation that instituted capitalist reform with superior results – reveals the answer. New Zealand's policymakers needed to attract more rewarding foreign direct investment, reduce social expenditures, support human capital, and promote the ideal of reform.

Reforms and Results

As indicated above, New Zealand's policy reforms came in two distinct packages. Roger Douglas engineered the first package, and Ruth Richardson engineered the second. Douglas' reforms encompassed four main pieces of legislation: the State Owned Enterprises Act of 1986, the State Sector Act of 1988, the Public Finance Act of 1989, and the Reserve Bank Act of 1989. Richardson pushed two major reforms through New Zealand's unicameral legislature: the Employment Contracts Act of 1991 and the Fiscal Responsibility Act of 1994 (Atkinson, 1997; Organization for Economic Co-operation and Development [OECD], 1999). Each new policy noticeably impacted the island nation's economy.

The State Owned Enterprises, State Sector, and Public Finance Acts moved New Zealand from a *machine* – or highly regulated – approach to managing government towards a *virtual* – or limited – approach to managing government. The laws promoted competition and shrunk the public sector by corporatizing and privatizing many government departments. Though still owned by the state, corporatized departments operated like private companies. The government ceased pre-determining inputs, which

gave the chief executive officers of these revitalized state owned enterprises the freedom to use performance goals and incentives to increase productivity and turn a profit. Many other state-owned enterprises, including New Zealand's telephone company and airline, became private companies when the government sold control to the outside investors (OECD, 1999; Richardson, 1997).

As a result of these three initial policy changes, New Zealand's enterprises – both public and private – became more customer-focused. For example, in the telecommunications industry, customers could have a new phone installed in two days instead of six weeks. Competition and efficiency also made prices fall. Industries like telecommunications and electricity experienced large end-user price reductions (Richardson, 1997). In addition, deregulation invited foreign investors into New Zealand. Table 1 shows a surge in foreign direct investment into New Zealand immediately after the State Owned Enterprises Act was instituted in 1986.

The Reserve Bank Act strengthened New Zealand's monetary policy by instituting two main changes. First, the law gave the Reserve Bank of New Zealand a single, clearly defined goal: maintain price stability. Second, the law gave the Reserve Bank of New Zealand more independence. The executive branch would no longer be able to influence the Bank's daily operations (Atkinson, 1997). These reforms allowed New Zealand to craft monetary policy that better served its citizens. As Table 2 indicates, the nation's rate of inflation stopped its wild growth after the Reserve Bank Act was instituted in 1989.

The Employment Contracts Act reformed New Zealand's wage-setting system by diminishing the power of unions. Individuals earned the right to negotiate employment contracts, and union membership – once compulsory – became voluntary. As a result, “[u]nion membership as a percentage of the employed workforce shrank from a high of 45% in 1989 to 23% in December 1994” (Glasgow, 1999, p. 8). Labor prices also fell. Graph 2 reveals compensation per employee only increased an average of 2.3% annually from 1990 to 2000. In comparison, wages had grown an average of 12.7% annually from 1976 to 1986.

The reforms of New Zealand's Great Capitalist Restoration ended with the Fiscal Responsibility Act of 1994. This law complemented the other reforms by making government fiscal policy more transparent. Reformers hoped stronger accounting and reporting standards would ensure disciplined public spending and good government (Glasgow, 1999; OECD, 1999; Richardson, 1997). This hope seemed to become reality from 1995 to 1997. During these years, as Table 2 indicates, New Zealand enjoyed both a budget surplus and a growing gross domestic product (GDP) (Glasgow, 1999; “Kiwis Turn,” 1996). The nation's once gloomy future appeared bright.

As of 2004, New Zealand's optimism has faded. The country's real GDP, tracked in Graph 3, has not continued trending towards strong growth. In fact, from 1984 to 2000, “the growth in New Zealand's GDP per head has been the slowest in the developed world” (New Zealand's economy, 2000, p. 69). New Zealand's post-reform unemployment rates, tracked in Graph 4, offer another disappointment. They rose above 10% in 1991 and 1992 and remained higher than 6% in 1997, more than a decade after the nation instituted its first reform. In addition, Graph 5 reveals that foreign direct investment (FDI) into New Zealand dipped dramatically – by more than 50% – after 1996. Since the nation has a historically low savings rate, it needs FDI to right its

balance of payments and fuel economic growth (“New Zealand’s Economy,” 2000). As Table 1 shows, New Zealanders had difficulty attracting FDI both before *and* after capitalist reform. In fact, from 1987 to 1997, New Zealand only received enough annual foreign direct investment to produce a positive capital account balance three times.

Foreign Direct Investment

While New Zealand’s rate of foreign direct investment was floundering, Ireland’s was flourishing (see Graph 5). For most of their histories, the two nations followed similar paths. Before the 1980’s, their tightly regulated governments, large welfare programs, and poorly performing agricultural-based economies paralleled one another. New Zealand began capitalist reform in 1984, Ireland in 1987 (Cooper & Lenane, 1999). Though New Zealand’s reforms garnered more early praise from economists, Ireland’s reforms have resulted in more lucrative foreign direct investment. Ireland attracted and sustained this FDI by (1) lowering taxes substantially, (2) privatizing strategically, and (3) using its Industrial Development Authority to market the nation.

During the 1990’s, the Irish government reduced corporate taxes from 40% to 28% as part of its economic reform package (Raphael, 1998). The lower tax rate had the intended effect. Foreign companies flocked to Ireland. These multi-national corporations established divisions and subsidiaries on Irish soil, making permanent investments in the country. Like the Irish, New Zealand’s reformers lowered the national tax rate during the Great Capitalist Restoration. The reduction from a 49% to a 33% corporate tax rate was substantial, but it did not give New Zealand an advantage in the foreign direct investment game (Marriott, 1997). Even the Organization for Economic Cooperation and Development (OECD) recommended that New Zealand push its corporate tax rate even lower than 33% to make it competitive with rates in nations like Ireland (“Economic Survey of New Zealand,” 2003).

Initially, New Zealand did manage to attract FDI when it privatized state-owned industries. Foreigners eagerly bought the government’s assets. However, economist Brian Gaynor called New Zealand’s privatization strategy a “disaster” (“John Campbell Interviews,” 2000) because a large percentage of the profits – in the form of dividends – from these businesses flowed out of the country. Since New Zealand chose to sell “a hundred percent of its assets to the highest bidder,” (“John Campbell Interviews,” 2000) only wealthy foreign corporations could afford them. In comparison, countries like Ireland and Australia privatized government assets in a piecemeal fashion. Smaller investors, including citizens, purchased these more affordable pieces of former state-owned enterprises. When the smaller investors received dividends, the domestic economy benefited. On the other hand, New Zealand’s strategy helped foreign shareholders and, therefore, foreign economies benefited. In fact, Brian Gaynor estimates that, in 2000, dividends “going from New Zealand to the overseas owners of New Zealand companies” (“John Campbell Interviews,” 2000) comprised \$1.5 billion of New Zealand’s \$7.1 billion deficit. If New Zealanders had privatized incrementally, they could have assured more reinvestment in their nation.

New Zealanders also failed to empower an organization to entice foreign investors to their country, while the Investment Development Authority (IDA) worked tirelessly to transform Ireland into a mecca for foreign investment. The IDA marketed

Ireland's skilled labor, European location, and tax incentives. In addition, the organization arranged investment packages, grants, and subsidies for foreign companies (Cooper & Lenane, 1999). The IDA targeted specific businesses and encouraged them to establish greenfield operations in Ireland ("John Campbell Interviews," 2000). This type of investment boosted Ireland's position in the world by creating jobs and expanding GDP (Mitchell, 2001). New Zealand might have enjoyed similar growth if it had created an organization like Ireland's Investment Development Authority.

Social Expenditures

Generous public social expenditure also hindered New Zealand's ability to grow jobs and GDP. The nation developed a "cradle-to-grave" (Atkinson, 1997, p. 43) welfare state in the early 1900's, and the Great Capitalist Restoration did little to reform it. Graph 6 tracks public social expenditure as a percentage of GDP for both New Zealand and Ireland. The numbers reveal that New Zealand actually spent less on welfare in the years before reform than it spent in the years after reform.

In comparison, Ireland moved away from its long history of socialized welfare by reducing government spending in the late 1990's (Glyn, 2002). For example, the Irish have done more than New Zealanders to curb unemployment compensation. Ireland limits the period of unemployment compensation and offers incentives and training to help its unemployed citizens return to work (Glyn, 2002). New Zealand has more passive, thus more expensive, unemployment programs. In 2003, the OECD noted that "[a]bout 9 percent of the working-age population [in New Zealand] has been on benefit for more than a year" ("Economic Survey of New Zealand," 2003). The statistics prove New Zealanders are taking advantage of New Zealand's lavish welfare state. The nation needs to set welfare limits and adopt stronger welfare-to-work policy to reduce social expenditures. These reforms will increase employment and help clot one of New Zealand's deepest economic wounds.

Human Capital

Ironically, while New Zealand supports its citizens with overly generous welfare programs, it fails to provide them with all the quality public services citizens deserve. New Zealand's education and healthcare systems performed poorly before capitalist reform, and they remained sub-par in the post-reform era ("Economic Survey of New Zealand," 2003). In a 1997 speech, Former Minister of Finance Ruth Richardson noted that New Zealand's future economic performance depended partly on these two areas of social policy. Richardson suggested her homeland use competition to increase choice and quality in education and healthcare.

In reference to education reform, Richardson said, "[W]hile there are good reasons for the government to fund schooling, there is no reason why the state should itself provide schooling directly" (1997, Structural Reform section, ¶ 3). She advocated allowing more private and cooperative organizations to provide education in New Zealand. Ireland adopted some of this strategy and has dramatically improved the quality of education and training for its citizens. As a result, the Irish have developed a skilled

workforce that employers recognize as valuable human capital for their businesses (“Economic Survey of Ireland,” 2003).

In reference to healthcare reform, Richardson said, “[L]et individual New Zealanders effectively take their share of public health funding and use it to purchase their own private health care plan” (1997, Structural Reform section, ¶ 9). Richardson believed this reform promoted competition between the public and private sectors of her homeland’s healthcare industry, which, in turn, improved the quality of medical services and programs. Unfortunately, New Zealand cannot look to Ireland for a model of healthcare reform. According to the Organization for Economic Cooperation and Development, Ireland has also failed to provide adequate medical services and programs to its citizens (“Economic Survey of Ireland,” 2003). On the other hand, New Zealand’s neighbor – Australia – has cultivated more public-private partnerships in its healthcare industry. As a result, Australians enjoy an improved quality of medical services and programs, and the Australian government fulfills an important obligation to its citizens (Kerr, 2002).

The Ideal of Reform

Throughout the Great Capitalist Restoration, New Zealand has also ignored its obligation to promote the ideal of reform. The New Zealand government did not sustain belief in reform because it (1) stopped selling the vision of capitalist reform to its citizens and (2) became mired in coalition building. When Roger Douglas and Ruth Richardson instituted New Zealand’s major economic and state sector reforms, they marketed those reforms as an answer to New Zealand’s troubles. “Voters could join up the dots and see it made sense” (Darwell, 2003, Politics of Reform section, ¶ 3). Citizens understood that embracing capitalism would be painful, but necessary. However, once Douglas and Richardson left office, capitalism had no true champion in New Zealand. When the economy slowed and New Zealanders began to question reform in the late 1990’s, politicians stepped back from capitalism instead of stepping forward to renew public confidence in reform (Kasper, 2002).

New Zealand’s government structure added to its politicians’ failure to promote and, therefore, sustain reform. In 1993, voters approved mixed member proportional representation in parliament. The new electoral process allowed citizens to cast votes for parties – which would select representatives to fill any seats they won – as well as for individual candidates. New Zealanders hoped the system would give a larger voice to minority parties (Glasgow, 1999). In effect, the system instituted an era of coalition government. The nation’s two largest political parties – National and Labour – no longer had enough votes to assume control of New Zealand’s one-chamber parliament. To gain votes, the large parties had to combine forces with smaller parties (Darwell, 2003).

Although the National party and the Labour party embraced reform in the Roger Douglas and Ruth Richardson eras, the parties adopted contrasting visions for New Zealand’s future after 1993. The National party, at its core, favored supply-side economics focused on trimming public spending and lowering taxes. The Labour party distrusted capitalist reform and advocated a return to more invasive government. Neither party wanted the opposition to govern New Zealand. As a consequence, compromising

to maintain power became more important to politicians than taking bold steps to keep the country's economy growing (Darwell, 2003).

Political compromise has weakened New Zealand's Great Capitalist Restoration. Recently, the Labour party Prime Minister, Helen Clark, even reversed some reform by renationalizing the country's airline, increasing the top tax rate, and expanding public spending (Darwell, 2003). Such turnarounds have not occurred in Ireland, which boasts a two-chamber parliament and more stable coalition governments. At the very least, all Irish political parties have always been united in their "opposition to British rule" ("About Ireland," n.d.). New Zealand's political parties do not have a similar common bond. The nation's lack of unity in politics and reform led Roger Kerr, the Executive Director of the New Zealand Business Roundtable, to make the following statement (2000):

[T]he progress of New Zealand has been like that of a car with a recurrent fuel blockage. It moved ahead rapidly for a while (1984-88) in response to a genuine economic crisis, stalled and then moved forward again for a short period (1991-92). Then it stalled again and is now being put into reverse. (p. 4)

As Roger Kerr implied, New Zealand needs to move forward, not backwards. The nation needs a government focused on serving citizens with solid and sustained economic policy, not a government focused on maintaining power with diluted economic policy.

Obstacles

Some economic analysts argue that the performance of New Zealand's capitalist reforms will never match the performance of Ireland's reforms because New Zealand faces too many natural obstacles. Many consider the country's size and location inherent disadvantages to building a strong economy. However, similar-sized Ireland's success and the vast opportunity in the Asian market silence these arguments of size and location (Kasper, 2002). New Zealand's commodity-based economy faces another obstacle: tariffs. Of course, this threat is more man-made than natural. Other nations' import restrictions prevent New Zealand from utilizing all of its comparative advantage in the agricultural industry. New Zealanders could attempt to overcome the tariff hurdle by cultivating trade agreements with countries outside their immediate area – countries like the United States, which protects its huge market with many import restrictions ("Economic Survey of New Zealand," 2003; Hilsenrath, 1999).

Analysts also note that New Zealand has not received the structural development funds Ireland has received. Historically, Ireland's agricultural economy, low income, and connection to Europe qualified it for monetary transfers from wealthier European nations. Today, Ireland continues to receive some support from the European Union (EU). New Zealand, on the other hand, has no powerful benefactors committed to developing its economy, which is a major disadvantage. Of course, New Zealand also avoids the strings that come with attachment to a larger government entity like the EU, which is an advantage (Cooper & Lenane, 1999). Ireland has already adjusted taxes and other portions of its fiscal policy to satisfy the European Union (Raphael, 1998). Meanwhile,

New Zealand maintains the freedom to establish policies that best serve its own citizens and only its own citizens.

Conclusion

Natural obstacles will not prevent New Zealand from sustaining economic growth. However, as New Zealanders have discovered, incomplete and vacillating capitalist reform will undermine economic growth. The leaders of New Zealand's Great Capitalist Restoration should be commended for adopting bold policies that rescued their nation from collapse. Now that the nation is saved, the policies should be modified and bolstered to improve their economic impact. New Zealand's current leadership needs to take four main action steps to achieve this goal.

First, the government must lower taxes and create an authority to attract foreign direct investment to New Zealand. Second, politicians must reduce social expenditures by reducing the population's dependence on the welfare state. Third, New Zealand must provide its citizens with education and healthcare programs that raise the nation's standard of living. Finally, New Zealand's leaders should renew their commitment to capitalist reform and lobby the public to revise the nation's ineffective electoral system.

If implemented, these policy changes should resuscitate the Great Capitalist Restoration and make free-market reform more effective in New Zealand. The nation will stop performing like a car with recurrent fuel blockage. Instead, New Zealand will roar back onto the road to economic growth and stay there for many, many miles.

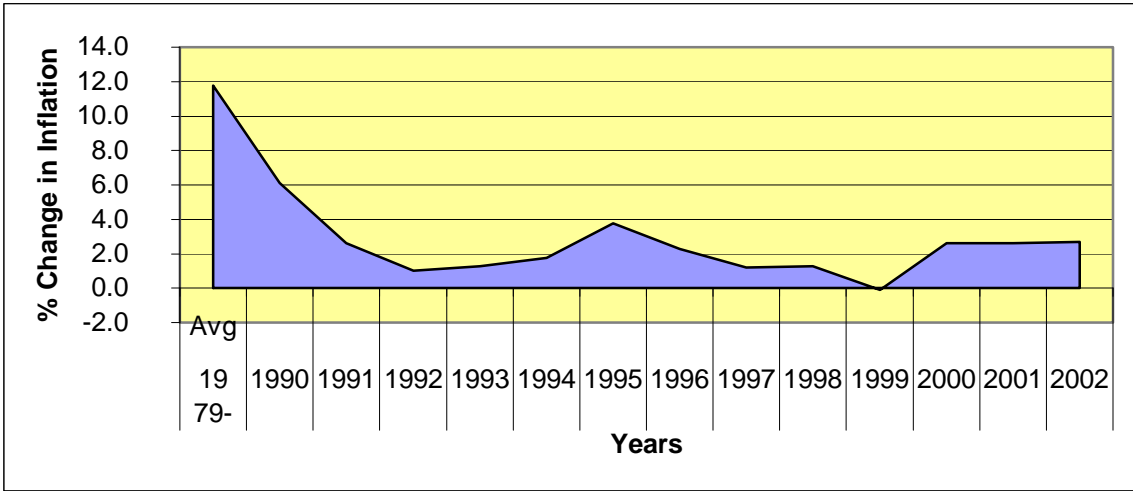
TABLE 1: New Zealand Balance of Payments, 1980-1997 (millions of US dollars)

| | 1980 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1993 | 1996 | 1997 |
|--|-------|-------|-------|-------|-------|-------|--------|--------|--------|-------|--------|--------|--------|--------|--------|
| Current Account | | | | | | | | | | | | | | | |
| Merchandise Exports | 5,394 | 5,385 | 5,595 | 5,836 | 7,245 | 8,831 | 8,846 | 9,190 | 9,555 | 9,735 | 10,468 | 12,176 | 13,478 | 14,166 | 13,841 |
| Merchandise Imports | 5,091 | 5,837 | 5,656 | 5,734 | 6,656 | 6,658 | -7,873 | -8,375 | -7,485 | 8,108 | -8,749 | 10,769 | 12,584 | 13,674 | 13,454 |
| <i>Trade Balance</i> | 303 | -452 | -61 | 103 | 590 | 2,173 | 973 | 815 | 2,070 | 1,627 | 1,719 | 1,408 | 895 | 492 | 387 |
| Services (net) | -834 | -373 | -356 | -470 | -467 | -604 | -772 | -830 | -835 | -948 | -651 | -434 | -236 | -337 | -636 |
| Investment Income (net) | -538 | 2,298 | 2,334 | 2,594 | 3,177 | 3,582 | -1,884 | -1,576 | -2,533 | 1,878 | -1,946 | -3,687 | -3,967 | -4,593 | -5,311 |
| Transfers (net) | 58 | 82 | 70 | 93 | 99 | 101 | 205 | 351 | 391 | 419 | 674 | 945 | 1,457 | 1,889 | 846 |
| <i>Current Account Balance</i> | 1,011 | 3,041 | 2,681 | 2,868 | 2,955 | 1,912 | -1,478 | -1,240 | -907 | -780 | -204 | -1,768 | -1,851 | -2,549 | -4,714 |
| Capital Account | | | | | | | | | | | | | | | |
| Direct Investment into NZ | 178 | 1,263 | 1,266 | 1,214 | 1,284 | 1,717 | 1,627 | 1,735 | 1,290 | 2,095 | 2,401 | 2,451 | 3,536 | 1,577 | 913 |
| Direct Investment from NZ | -107 | -422 | -309 | -592 | -435 | -373 | -1,896 | -1,594 | -690 | 805 | -1,281 | -1,700 | 356 | 998 | 201 |
| <i>Foreign Direct Investment (net)</i> | 71 | 841 | 957 | 622 | 849 | 1,344 | -269 | 141 | 600 | 2,900 | 1,120 | 751 | 3,892 | 2,575 | 1,114 |
| Portfolio Investment (net) | - | - | - | - | - | - | 30 | 171 | -151 | 376 | 2,147 | 2,094 | 2,643 | 3,813 | 238 |
| Other Capital Flows (net) | -715 | -545 | 1,206 | -621 | -839 | 3,134 | -501 | 563 | -1,159 | 3,151 | -4,885 | -2,238 | -2,633 | -3,403 | -2,677 |
| <i>Capital Account Balance</i> | -644 | 296 | -249 | 1 | 10 | 1,790 | -7,420 | 875 | -710 | 125 | -1,618 | 607 | 3,902 | 2,985 | -1,325 |
| Errors and Omissions (net) | 203 | 1,199 | 895 | 255 | 697 | 782 | 1,000 | 544 | 104 | -823 | 49 | 503 | -1,718 | 1,163 | 4,087 |
| <i>Overall Balance</i> | 1,424 | 1,546 | 2,037 | 2,612 | 2,248 | 2,921 | -1,217 | 179 | -1,511 | 1,477 | -1,772 | -657 | 335 | 1,599 | -1,954 |
| Reserve Account | 1,424 | 1,546 | 2,037 | 2,612 | 2,248 | 2,921 | 1,217 | -179 | 1,511 | 1,477 | 1,772 | 657 | -335 | -1,599 | 1,954 |

Source: IMF: *International Financial Statistics Yearbook*, 1998. Derived from Glasgow, K. (1999). *New Zealand: The wonder down under*. (Harvard Business School Case 9-700-022). Boston, MA: President and Fellows of Harvard College.

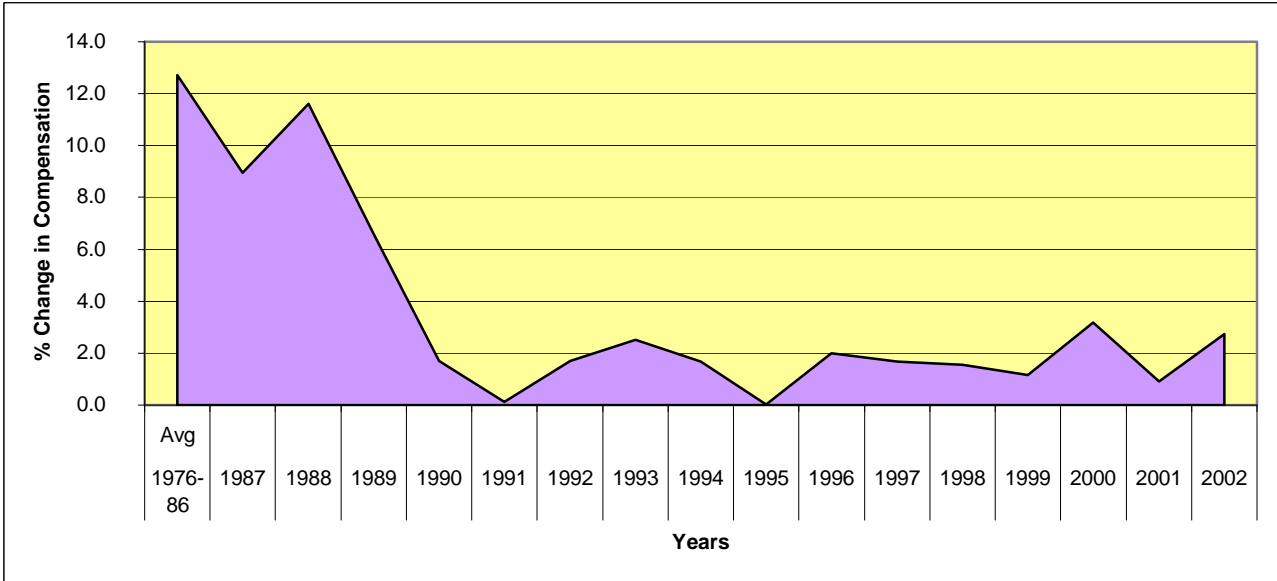
Graphs

Graph 1: New Zealand Inflation (Percentage change from previous year)



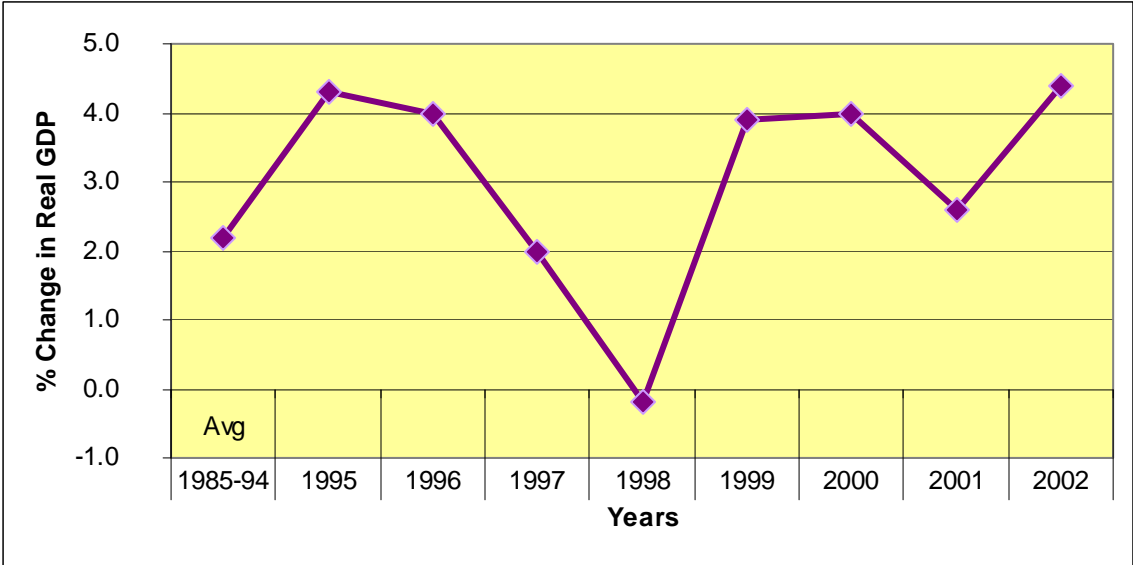
Source: Derived from Organization for Economic Cooperation and Development (OECD), *Consumer prices indices*. (2003).

Graph 2: New Zealand Compensation per Employee (Percentage change from previous year)



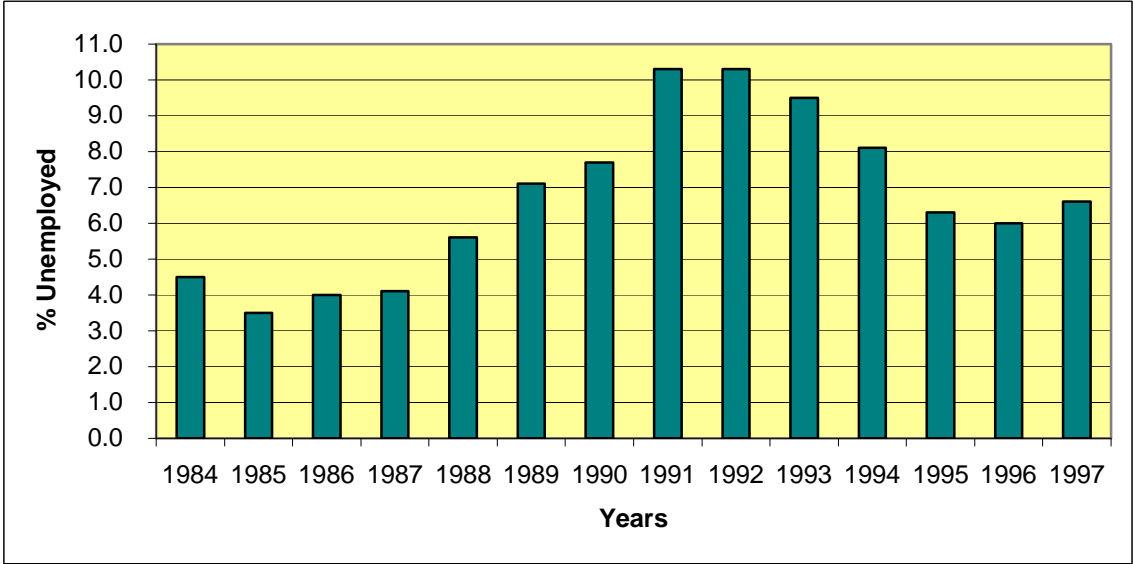
Source: OECD, *Compensation per employee in the business sector*. (2003).

Graph 3: New Zealand Real GDP (Annual percent change)



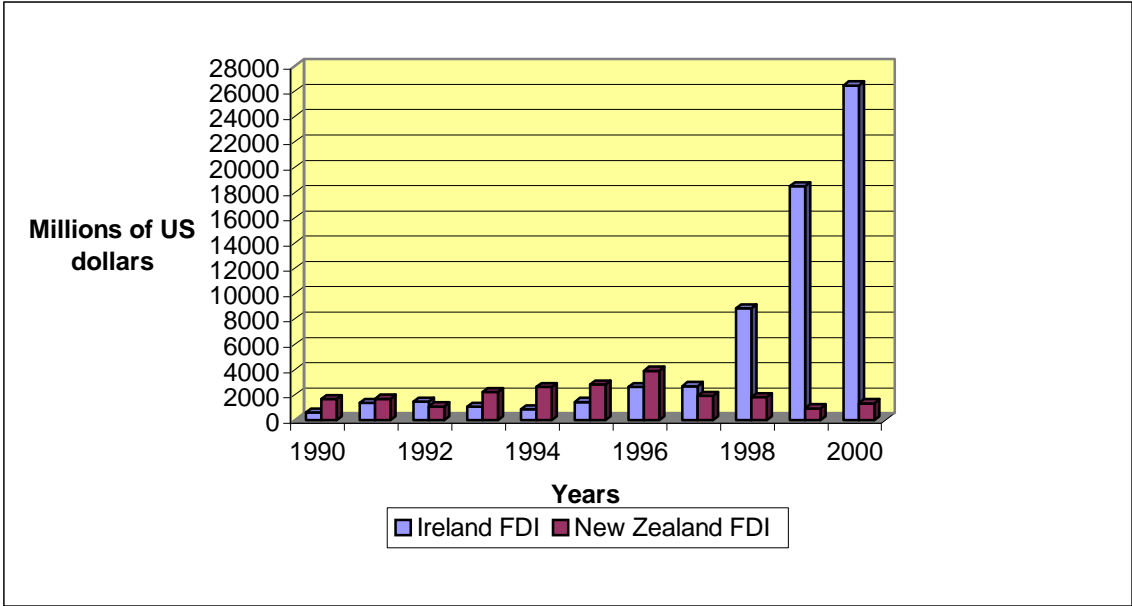
Source: IMF: *World Economic Outlook*. (2003, September).

Graph 4: New Zealand % of Population Unemployed



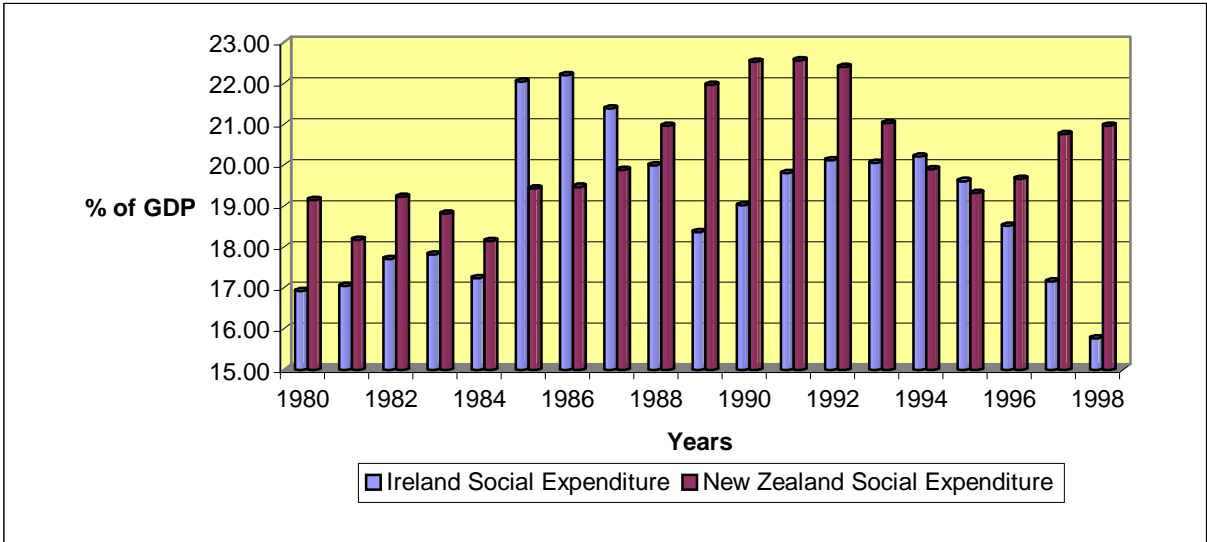
Source: OECD, *Economic Outlook*. (1998, December); Statistics New Zealand Website (www.stats.govt.nz). Derived from Glasgow, K. (1999). *New Zealand: The wonder down under*. (Harvard Business School Case 9-700-022). Boston, MA: President and Fellows of Harvard College.

Graph 5: OECD Direct Investment into New Zealand



Source: OECD, *OECD Direct Investment from Abroad: Inflows*. (2001).

Graph 6: New Zealand and Ireland Public Social Expenditure as percentage of GDP



Source: OECD, *OECD Public Social Expenditure as a percentage of GDP*. (1999).

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