Keynote Address

Governance: Promoting Sound Development

Management Lessons from New Zealand

Ruth Richardson
Finance Minister of New Zealand, 1990–1993

*The Honorable **Ruth Richardson** was the first Finance Minister in Jim Bolger's National Party Government in New Zealand (1990–1993), in which capacity she was the driving force behind her country's dynamic reform agenda. Ms. Richardson was first elected to Parliament in 1981. As a member of the opposition, she acted as Shadow Minister of Education from 1984 to 1987, and as Shadow Minister of Finance from 1987 until her party assumed power in 1990. Since completing her fifth term in Parliament in 1994, Ms. Richardson has been in demand as a policy consultant to governments around the world on streamlining governance and public sector reforms. She is currently a Director of Wrightson Ltd and the Aoraki Corporation, and Chairman of Dairy Brands Ltd.*

The quality of a country's economic policy and the integrity with which that policy is implemented are crucial factors for its prosperity. Compared to these factors, natural resources are usually of strictly limited value to a country — a fact attested by the existence of many poor but resource-rich countries, and rich but resource-poor countries. Cultural factors such as the capitalist ethic and civic trust are much more important for prosperity than natural endowments, yet a poor policy framework will still prevent even the most promising cultural conditions from being realized in the best economic outcomes.

It is true that a rich country may often be able to "carry" a poor policy framework for a period of time before its underlying contradictions become too pressing and demanding to be addressed, whereas a poor country with an inadequate policy framework more often and more rapidly reaches crisis point. But rich or poor, a country cannot indefinitely blame inferior economic performance on international trading conditions or other such factors.

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It is the quality of governance that makes the crucial difference; in particular, the quality of the development management and the policies chosen to advance a nation's economic and social ambitions. At the end of the day — and no matter what the characteristics of an economy — prolonged low growth, high unemployment, high inflation, and indebtedness are effectively political choices.

For instance, a country with high unemployment resulting from inflexible labor market practices effectively makes a political choice to retain its unemployment level. That country could choose — as New Zealand has done — to tackle vested interests through liberalizing its labor market, but instead chooses to opt for the sclerotic status quo.

New Zealand was a rich country which was reduced to "poor country status" by first world standards, as a result of poor policy choices. A heavily overregulated and inefficient domestic economy, high protective barriers, and inconsistent and irresponsible monetary and fiscal policies had caused New Zealand to have the worst productivity growth rate, and the worst economic growth per head, of any country in the Organisation for Economic Co-operation and Development (OECD).

By 1984 we were also approaching crisis point, since the rapid buildup in our Government and overseas debt — another OECD record — had become unsustainable. New Zealand's exports, though growing more diversified, were still dominated by bulk unprocessed pastoral products, essentially a developing country's export base. Our poor economic performance could no longer plausibly be blamed on external influences. We had run out of excuses as an economy, and the need for reform was undeniable.

Reforms in Brief

The New Zealand economic reforms took place under two governments, starting in 1984. In the course of 10 years our economic performance was transformed. Few other countries have undertaken reforms of such far-reaching scope or mutual consistency. As the OECD put it in its latest survey of New Zealand: "While other OECD countries have pursued similar policies, few, if any, have done so in the context of such a coherent overall framework, stressing predictability, transparency and accountability."

The reforms included:

- The internationalization of the economy through the reduction of border protection and abolition of exchange controls.

- Wholesale domestic deregulation in both goods and factor markets, including major liberalization of the labor market.

- The transformation of Government through the corporatization and privatization of state trading activities, and major performance management reforms to the core state sector.

- The focusing of monetary and fiscal policy on sound medium-term objectives rather than short-term and unsustainable objectives. Monetary policy is now dedicated to price stability and fiscal policy to reduce debt and to run balanced budgets over time.

In sum, the reforms greatly increased the role of market forces in creating wealth, while putting in place a sound macroeconomic framework to ensure that poor monetary and fiscal settings would not compromise the benefits from the new microeconomic climate.

There were two major waves of reform. An initial wave of rapid but uneven liberalization was undertaken by the Labour Government elected in 1984. A second wave of reforms, which included the liberalization the labor market and the reining in of Government overspending, removed the final major anomalies in the policy framework and set the scene for economic recovery. This final wave of reforms was undertaken in the first term of the 1990 National Government, in which I served as Minister of Finance.

A crucial component of New Zealand's reforms was the strong commitment from key political players. The most successful periods of reform were characterized by a clear strategy among ministers, and a consistent application of that strategy throughout the public sector. The poor performance of the economy, and the powerful vested interests opposed to change, meant that a sense of urgency was important in maintaining the momentum of reform.

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Just as important was the placing of high quality people in key public sector positions to ensure that the vision of the reformers was not frustrated during the implementation stage by a bureaucracy resisting change. Effective communication of the rationale for the reforms was crucial. Business needed to understand the overall reform strategy so as to be in the best position to realize its benefits. And a sufficient percentage of the public needed to be persuaded to give reform the benefit of the doubt during a testing initial period when the adjustment costs outweighed any tangible benefits.

Securing the support of key private sector groups to the cause of reform was an important factor in securing public acceptance of the liberalization program. So too was the overall resolve of the Government. As the reforms proceeded, sector groups typically gave up demanding to have their privileges restored, and instead began to urge the Government to treat them evenhandedly by moving to reform those sectors that were not yet liberalized.

After coming through the difficult initial period, the New Zealand economy has now performed so robustly that the reforms have been described by the OECD as "remarkably successful." Since economic recovery began in 1991, growth has averaged between 3 and 4 percent per annum, the unemployment rate has fallen to 5.9 percent (one of the lowest in the OECD), and the Government's budget has swung into surplus, allowing taxes to be cut while simultaneously paying off all Government overseas debt. New Zealand's credit rating has been upgraded.

Surveys such as that of the World Economic Forum have placed New Zealand among the leading nations for competitiveness. **The Economist** has called New Zealand's monetary and fiscal policies "the world's best." The 1996 Survey of Economic Freedom of the World ranks New Zealand as one of the top performers, second only to Hong Kong. And German anticorruption organization Transparency International has named New Zealand the least corrupt country of the 41 it surveyed — a reflection both on our culture and on the degree of economic freedom now possessed by New Zealanders.

With all these favorable outcomes, it is no wonder that the **Financial Times**, in an article entitled *Lessons from the Antipodes* (12 March 1996), stated that "New Zealand has demonstrated that orthodox economic reforms, energetically executed, can make a difference to an economy's prospects. For this reason, it offers important lessons." In my view the most important of these lessons are:

- The value of comprehensive reform. The New Zealand reforms were both microeconomic and macroeconomic. They encompassed capital and labor markets, goods markets and the Government sector.

- The importance of balance in reform. The New Zealand economy began its period of sustainable economic growth only after the last principal obstacles to growth (namely an inflexible labor market and Government overspending) had been effectively tackled.

- The value of a medium-term focus. All New Zealand's principal reforms had such a focus.

- The value of political commitment, a clear strategy, and high-quality implementation by key people.

- The importance of effective communication and a sense of urgency in reform.

Rethinking the Role of the State

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The New Zealand reforms involved a rethink of the entire role of the State. Over time, Government in New Zealand had become greatly overstretched: it was undertaking many activities where it had no legitimate role, and was generally doing badly those things that *did* constitute its core functions. Objectives were often confused or conflicting, accountability weak, incentives for efficiency minimal, and management hamstrung by centralized decisionmaking and excessive bureaucratic rules.

The task facing our reformers was to identify those areas where the state had a legitimate role, then determine in each instance how that role could be most efficiently and effectively carried out. This inevitably meant a reduced Government presence in the economy, as well as a transformation in how the State undertook its remaining functions.

The State's roles had included regulating private sector activity, producing many goods and services itself, and providing social services. As regulator, the state has now taken on a much less obtrusive role, though its core function of setting the legal framework against which open and competitive markets can operate remains, of course, a quite crucial function of Government. New Zealand now combines generally sound law with an uncorrupted, independent and relatively competent judiciary, and thus scores highly as an economy where the rule of law is upheld.

The Government has also reduced its role as a participant in economic activity, through corporatizing and privatizing many state trading activities. When it comes to the provision of social services, by contrast, the changes have mostly concerned how the Government discharges that function, rather than involving a reduction in the overall Government presence.

A decade of reforms in New Zealand's public sector has resulted in a model of public sector management that has brought world acclaim. The model starts at the strategic level, where cabinet Ministers decide on their key priorities. As the only participants with democratic legitimacy, ultimately it is only Ministers who can set the desired social and economic outcomes resulting from Government action.

Each year a document is produced setting out the Government's vision of the outcomes it wishes to see achieved in the years ahead. Well in advance of the presentation of the budget, the Government also publishes a Budget Policy Statement — another strategic document incorporating the Government's economic and social ambitions. This document binds the whole of the Government to the published strategy.

In line with the strategy, individual Ministers in turn choose the outputs they wish to purchase from their departments and from other State entities in order to help realize the outcomes sought by Government. The chief executive of each department is responsible for providing the relevant Minister with the contracted outputs.

The chief executive is on a fixed-term contract, and has wide discretion to manage departmental inputs — including labor. Labor practices are flexible, with unionism voluntary and a large percentage of state sector workers covered by individual contracts (also the case in the private sector). Pay-by-performance is commonplace. Often tasks are contracted out to private sector organizations that can perform the function more efficiently; there is no presumption that Government is the preferred provider.

Besides purchasing outputs, the Government also has an ownership interest in the assets tied up in Government agencies. In the core state sector, each department must calculate a balance sheet, and a system of capital charging has been introduced. These twin disciplines provide a powerful incentive for departmental chief executives to manage their balance sheet so as to make the most efficient use of their assets.

But it is the area of state trading activities where the Government's ownership interest has been most radically reassessed. Prior to the reforms, most trading activities were contained in governmental departments, facing poor incentives, bureaucratic controls, and often mixed objectives. Service was notoriously poor, and many activities ran permanently at a loss. Under the reforms, these activities were separated into distinct organizations, becoming state-owned enterprises (SOEs).

SOEs are registered under the Companies Act and are required to operate in most respects as private companies. They have a clear profit objective and their boards are largely free from political control. They must borrow on their own account and pay tax and dividends to the Government. Nor are they shielded from facing private sector competition. Day-to-day running of an SOE is in the hands of its board and management.

The shares are held by two ministers. The sole task of the shareholding ministers is to manage taxpayer ownership interest by appointing the board, setting dividend policy, and monitoring overall performance. Under the improved incentives provided by the new regime, there were some huge productivity increases following corporatization, some big real price reductions and some rapid transformations into profitability on the part of SOEs.

While these developments were welcome, in the case of the great majority of SOEs, there were strong economic reasons for taking the further step of transferring the business to the private sector. Only in the private sector would productivity be maximized, and each business be best placed to undertake new investment. Corporatization was a halfway house, and the performance incentives and monitoring mechanisms under Government ownership, while much improved, still did not match those available in the private sector, where shares were freely tradeable and companies subject to takeover.

There was also a genuine risk of policy slippage over time. Political fashions can change, and commercial considerations can easily become subordinated to political considerations once again, given the often short time horizons of the political process. The slow infiltration of politics into SOE policy can be manifested in terms of soft required rates of return, interference in key decisions such as pricing, or excessively political board appointments.

For all of these reasons, a major privatization program was undertaken in New Zealand. Policymakers were insistent that prior to any privatization the market must be deregulated, e.g., telecommunications, banking, and transport. Most of the sales were by open tender and it transpired that all were trade sales. Since the objective of the program was to maximize return to the taxpayer, very few restrictions were placed on who could enter the bidding.

In a highly successful series of sales, around NZ$14 billion in assets were privatized — many to overseas interests. Proceeds from the privatization program were dedicated wholly to the retirement of Government debt.

The wholesale separation of commercial functions from other functions of governmental departments has been one aspect of an overall program of restructuring the public sector so as to make objectives and accountability more unambiguous. Thus the provision of policy advice has typically been separated from

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the operational functions of departments, partly to remove any conflict of interest from those involved. For similar reasons, the funding of activities has been separated from their provision.

Regulatory functions have also been isolated into separate agencies. In any given area of policy, a small ministry is likely to be giving policy advice, and other agencies acting as purchaser or provider. Almost the whole of the public sector has been restructured along these lines.

Any government that takes seriously its role as purchaser of outputs and as owner of assets will put in place sound systems to measure performance. After all, if you cannot measure it, how can you manage it? Here, too, the New Zealand public sector performance management model leads the world. Information requirements right through the public sector are substantial. In line with the new stress on outputs, all departmental reporting and financial accounting is on an output basis.

At the aggregate level, the New Zealand Government now calculates an annual operating statement on an accrual basis, as well as a consolidated balance sheet for the whole of the State sector — the only country in the world to do so. Fiscal projections are also open and transparent. By law, the Government must produce and publish twice-yearly economic and fiscal projections, including a set of forecasts just prior to each general election.

The Government has gone further by binding itself to conduct fiscal policy in line with certain specified principles of responsible fiscal management. These principles are contained in the Fiscal Responsibility Act 1994, which I introduced to Parliament as Minister of Finance. The principles include running balanced budgets over the course of the business cycle, reducing debt to prudent levels, and pursuing policies consistent with a reasonable degree of predictability in future tax rates.

Any departure from the principles must be temporary, and must be accompanied by a published strategy for ensuring that fiscal policy soon complies again with the principles of responsible fiscal management. Thus the Fiscal Responsibility Act still allows an elected government to make a full range of expenditure decisions in line with its social priorities, but prevents irresponsible deficit financing which damages economic growth and subordinates long-term to short-term considerations.

Principles of Good Governance

The Asian Development Bank has stressed four key principles of good governance — accountability, transparency, predictability and participation. In the concluding section of this paper I add a fifth: *credibility*. The New Zealand public sector reforms rate highly on all of these principles.

1. Accountability

In New Zealand, accountability has been enhanced at all levels. Departmental chief executives are now directly accountable for their performance in delivering their departments' outputs, and even ordinary employees are more accountable than under the old union-dominated state sector. The outputs of a department are now clearly specified. Both Ministers and the wider public can see what they are buying, how much it costs, and who is responsible.

Privatized SOEs now face the disciplines of the competitive marketplace. SOEs that for various reasons have not yet been privatized still face much increased accountability: shareholding ministers seek an economic rate of return on the taxpayers' assets, and are empowered not to reappoint directors after their terms have expired.

There are other means by which accountability in government can be strengthened. Free and open financial markets are an important ally of good government. They sit on daily judgement over a country's economic policy, and bring home to a government visibly, and rapidly, the medium-term consequences of poor policy. Where asset prices appear misaligned, they usually reflect underlying imbalances in economic policy. By so doing, they put pressure on policymakers to address those imbalances.

In New Zealand, the liberalization of exchange controls and interest rate controls in the mid-1980s, along with the clean float of the New Zealand dollar, played an important role in encouraging governments to adopt prudent policies — especially in the area of fiscal and monetary policy.

2. Transparency

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The New Zealand model rates equally highly in terms of transparency. Clear operating rules and a free flow of information assist economic decisionmaking, reduce uncertainty, and increase confidence in the legitimacy of a government (whether democratic or not). New Zealand has an Official Information Act [1982] policed by an independent Ombudsman. That legislation sets down the general principle that information should be made available in the absence of compelling reasons otherwise.

Crown-owned entities report regularly to Parliament, while New Zealand's fiscal reporting is the fullest in the world. The Government's overall fiscal strategy must be disclosed in accordance with the requirements of the Fiscal Responsibility Act.

Other important arms of economic policy typically operate also under substantial transparency requirements. For instance, the Reserve Bank Act 1989 unambiguously sets down "stability in the general level of prices" as the principal goal of New Zealand's central bank. A public Policy Targets Agreement between the Minister of Finance and the Reserve Bank Governor details how the Bank will perform its function of maintaining price stability.

The Bank has day-to-day operating autonomy. However, twice-yearly it must produce a detailed monetary policy statement, which is tabled in Parliament and examined by a parliamentary select committee. A government can temporarily direct the Reserve Bank Governor to conduct monetary policy in accordance with an aim other than price stability, but such an action (which is most unlikely to occur) must again be transparent: any such "override" would need to be tabled in Parliament.

3. Predictability

Where policies are transparent and accountable they are also likely to be predictable in their impact. Thus it is in New Zealand. Monetary policy furnishes a good example: the operational autonomy of the Reserve Bank, its single and explicit objective, and the transparent contracting between Government and Bank lends policy a high degree of predictability. This predictability came about through explicit design: the more credible the Government's commitment to price stability, the lower the inflation risk premium in interest rates, and the more confidently will business be able to invest in the expectation of a low inflation environment.

Similarly, the transparency and medium-term focus of New Zealand's public sector management model lends fiscal policy increased predictability.

The requirement in the Fiscal Responsibility Act to run a balanced budget over the course of the business cycle, along with the high level of information disclosure required by the Act, is an explicit mechanism for entrenching sound fiscal outcomes over time. Governments are under constant short-term pressure to run fiscal deficits.

But so long as the Fiscal Responsibility Act remains in place — and it is supported by all but one minor party in parliament — business can be confident that fiscal policy will be conducted in a responsible manner. Already the Act has helped change the nature of political dynamics and the wider policy debate: the current coalition government wishes to be seen as "fiscally responsible" in terms of the legislation, while the private sector regards compliance with the Act a key aspect of responsible economic management.

4. Participation

Participation is a principle rightly stressed by the Asian Development Bank. One of the features of a market economy is that it is a vast network of participation on a voluntary basis. Every consumer is a voluntary participator, as is every producer, every investor, and every worker who uses the opportunity provided by a free labor market to gain employment. Clearly the quality of those participations will be greatly improved where there is strong civic society.

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Government cannot itself create civic society, but the quality of its own participation can make a big difference to the success of an economy. In New Zealand prior to the economic reforms, participation by Government was far too obtrusive and largely of the wrong sort. Government did everything from running financial institutions to participating in tripartite wage-setting decisions (employers, unions, and Government) that were the proper preserve of the relevant private sector players. The predictable outcome was poor economic performance.

The Government now participates in the economy to a much reduced extent, but with greater effectiveness. All governments have a crucial role in assisting private sector participation by upholding the rule of law, allowing the free flow of information in both public and private sectors, and making the rules of the economic game as transparent as possible. As we have seen, the New Zealand model performs well on these criteria.

Shortcomings of the New Zealand Reforms

Not all of the New Zealand reforms have been of the same quality. In two sectors in particular — health and education — policies have so far lacked the coherence and boldness of most other elements of the reform program.

Health and education are politically sensitive sectors where powerful vested interests make progress particularly difficult. In reforming these services, there has been some limited progress in putting in place better supply side structures, but hardly any in introducing greater choice on the demand side. As a result, improved outcomes have been limited, and widespread public dissatisfaction with these services persists.

In restructuring New Zealand's publicly-funded hospital sector, moves were at least made towards greater accountability and transparency by (i) separating the funding of hospital services from their provision, (ii) by setting up hospitals on a more businesslike basis, and (iii) by explicitly contracting for hospital services. But for political reasons, the Government has been relatively weak in demanding high-quality performance from the hospital sector. Moreover, there is still relatively little competition in the health system, either between public health care providers or between the private and public sectors.

The Government shelved a plan to let individual New Zealanders effectively take their share of public health funding and use it to purchase their own private health care plans. Thus an initiative that would have broken up the uncompetitive and monolithic public health service by allowing individuals greater choice and participation did not in the end proceed.

In the field of education, a similar unwillingness to adequately think through the Government's role from first principles has been experienced. While there are good reasons for the Government to fund schooling, there is no reason why the State should itself provide schooling directly.

Such a task can be most effectively left to private sector incentives and disciplines through a voucher system or similar scheme. Unfortunately, in New Zealand we are still at the stage of attempting to make Government-run schools work better. That is inevitably a difficult task in a sector noted for its inflexibility, unresponsiveness, and dominance by teacher unions. While some limited improvements have been introduced, genuine parental choice and the ability to participate as a consumer of education remains largely unrealized.

The lesson from New Zealand regarding health and education is that deviation from sound first principles will result in unsatisfactory outcomes. As in other areas of policy, halfhearted reform sells the public short. Only by bringing about maximum choice on the demand side, so that control passes from producer to consumer, will we make progress of similar quality to that elsewhere.

Conclusion

We possess a considerable body of theory and international evidence concerning the role of government, and the type of policy regime that most encourages economic development. Too often, however, political considerations and the demands of vested interests prevent a government from acting in a manner consistent with sound outcomes.

We know that open and competitive markets are the most effective generators of wealth over any reasonable period of time. The role of Government is to support markets by maintaining a consistent and predictable legal framework, involving few restrictions on contracting and maximum transparency in the conduct of economic policy. While this may sound a comparatively minor task for government, it is a crucial role which is performed well by few countries anywhere. One of these countries is New Zealand.

Too often, political considerations and the demands of vested interests prevent a government from acting in a manner consistent with sound outcomes.

Credibility

Much that is important in governance ultimately comes down to the issue of credibility. Does the government adhere to a consistent set of principles, and pursue policies that are not in contradiction with each other? Can private sector participants make decisions in the confidence that the government will act predictably in given circumstances? And at the level of implementation, will policies be carried through in a manner consistent with maintaining and strengthening the entire culture of a market economy?

New Zealand's reform program largely meets these tests of credibility. For instance, by making fiscal policy more predictable, transparent, and accountable, the Fiscal Responsibility Act has improved the credibility of Government, transformed the nature of the political debate on fiscal policy, and assisted materially in generating better private sector performance.

Institutional Design

These outcomes from the Fiscal Responsibility Act illustrate how improved institutional design has a positive impact on the behavior of participants in the economy, both in the public and private sector. Many other New Zealand institutional reforms also demonstrate this principle. For example, the discipline provided by the Reserve Bank Act has led successive governments to pursue price stability in preference to policies that favor the short term at the expense of the medium term. That Act has also changed private sector behavior by reducing inflation expectations and business uncertainty.

The new institutional framework under the State Sector Act 1988 and the Public Finance Act 1989 promoting a performance management regime involving accountability and transparency throughout the public sector — such as the requirement to produce a departmental balance sheet — has improved performance at all levels.

And in the labor market, the change in framework under the Employment Contracts Act 1991 from centralized bargaining to free contracting has led to big cultural changes at the level of the firm, in the form of greater cooperation between employers and employees, increased flexibility, and reduced industrial conflict. Correct design of the institutional framework clearly makes a big difference to economic performance.

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Good governance is epitomized by a framework of policies that are consistent, transparent, predictable, and credible. The State should not attempt to perform tasks that are the proper province of the private sector, but should rather provide the overall climate within which markets can flourish.

Private sector participants, for their part, must be prepared to take the lead in investment decisions, and look to their own skill and resources in the search for higher productivity, rather than seek to be rescued by government rules that confer privilege on them while raising costs on others. And private sector participants must observe the legitimate rules of competitive markets and stay within the law.

A policy regime that realized this partnership with a high degree of effectiveness would look like this:

- A monetary policy aimed at price stability, and an institutional mechanism — such as New Zealand's Reserve Bank Act — that effectively locks price stability into the economic framework.

- Fiscal policy that does not attempt to be actively counter-cyclical, but which aims to run balanced budgets over the course of the business cycle — preferably with an institutional mechanism such as New Zealand's Fiscal Responsibility Act as a means of cementing in good fiscal behavior.

- A government sector that is only performing those functions that could not more efficiently be performed by the private sector, and is undertaking those tasks in as efficient, transparent, and accountable a manner as possible. Commercial businesses belong in the private sector.

- A tax system where low rates of tax are conferred over broad tax bases.

- Open and competitive markets without price controls or monopoly powers conferred by statute.

- No trade barriers. If import protection is deemed necessary, tariffs are generally preferable to quantitative controls. Rates of tariff should be as even as possible to minimize distortions.

- Open, competitive, and lightly regulated capital markets, including an inward investment regime that welcomes foreign capital.

- A labor market where there is complete freedom to contract between employer and employee (and freedom to form associations voluntarily).

- Most important of all, clear and consistent laws that participants in the economy can be confident will be upheld in the courts. Strong property rights and an independent judiciary free of corruption are two vital elements of the machinery that is necessary to support markets.

There is no easy recipe for economic success. But the global lessons — whether from the spectacular emergence of East Asia or the radical reform of New Zealand — are the same. More important to sound development management than anything else is the successful combination of good governance and sound economic fundamentals — stable macroeconomic management, investment in people, open markets, and allowing prices to reflect economic scarcity. For most countries, realizing such a template of policies would require a substantial adjustment in how the government sees itself —

from government-as-controller to government-as-setter of the framework within which markets can operate. But the lesson from New Zealand and other countries is that such a transition is possible, and that the economic and social benefits abundantly repay any transition costs. All that is required is the political will.

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