A Flexible Economy?  
Entrepreneurship and Productivity in New Zealand

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August 1, 2004

Abstract: This paper (a) provides a framework for quantifying any economy’s flexibility, and (b) reviews the evidence on New Zealand firms’ birth, growth and death. The data indicate that, by and large, the labour market and the financial market are doing their job.

How business-friendly is New Zealand? Are there barriers in the way of entrepreneurship? This paper provides a framework for measuring any economy’s flexibility and reviews the evidence on the New Zealand economy’s flexibility.

Productivity in New Zealand’s firms grew unduly slowly during the 1990s, according to the Treasury. Output per hour of work grew at around 1 percent per year. The main reason for slow productivity growth, by the Treasury’s analysis, was a low rate of investment. Whereas Australia’s capital-labour ratio grew 56 percent between 1988 and 2002, New Zealand’s grew just 24 percent (Treasury, 2004, pp.21-24; Black et al., 2003). Labour productivity growth rose in the late 1990s and early 2000s to a rate comparable with Australia’s, at around 1.7 percent (Buckle et al., 2004), but concerns

¹ Presented at the workshop on “Productivity: Performance, Prospects and Policies,” sponsored by the Treasury, the Reserve Bank and the Ministry of Economic Development, Wellington, July 28-29, 2004. I thank Robert Buckle, Tim Hazledine and Robert Joss for comments. This work was supported by the Center for Global Business and the Economy at the Stanford Graduate School of Business.
continue to be expressed about New Zealand’s slippage in the world per-capita income ranks and about the prospects for future growth.

Small population and remoteness might hold growth back. Producers may be unable to attain economies of scale because the domestic market is small and foreign markets are distant (Skilling, 2001). However, this explanation is fatalistic. You can’t change geography. Are there other sources of low growth that are less fixed?

Markets can malfunction because of inadequacies in the institutional environment or in policy. Government could impede markets either by doing things it should not do or by failing to do things it should do. For example, the government might obstruct entrepreneurship by setting onerous licensing rules for new firms. On the other hand, an undersupply of financial-market regulation could make it hard for firms to grow. In what follows I ask whether markets are being hampered by too much or too little government.

Historically, the big issue in New Zealand was too much government. Idiotic interventions hamstrung the economy (Tower, 1979; James, 1986; Evans et al., 1996). Much of New Zealand’s slide in the per-capita income rankings is attributable to the pre-1984 overregulation. New Zealanders are indebted to those who, twenty years ago, battled to dismantle an unworkable economic system. That problem having been addressed with the post-1984 reforms, however, we should consider the possibility that, today, the government is neglecting to do some of what it should be doing. Informational asymmetries—lemons-market problems and the like—mean that complex markets need underpinnings if they are to work as they are supposed to (as discussed in McMillan, 2002). The task of providing those underpinnings falls in part on the government.
In one strongly expressed view, government regulation has continued, even since the reforms, to obstruct business. Roger Kerr of the New Zealand Business Roundtable has complained of the “quagmire of regulation” which, because it has high compliance costs and undermines property rights, is a “massive deterrent to investment and economic growth” (Kerr, 2000). In a keynote address to the New Zealand Association of Economists, Wolfgang Kasper said the government is stifling enterprise through “benevolent state paternalism,” bringing “poor growth and a stifling, though comforting serfdom,” so New Zealanders today are not “daring to be self-reliant and free.” He called for “supply-side policies” to remove “unjustified barriers to entrepreneurial activity” (Kasper, 2002b, p. 18, and 2002a, p. 15).

The government concurs with the Business Roundtable diagnosis—at least in part—in highlighting entrepreneurship. “Growing the New Zealand economy is about growing the individual businesses that comprise the economy,” noted the 2004 Treasury report (p. 70). “For this to occur the business environment must be one where the incentives encourage enterprise and innovation, where firms seek out and develop profitable new opportunities, and where well performing and more productive firms will prosper, while poorer performers exit.” Helen Clark said one of the “key areas for action” for higher growth is “creating an environment in which small and medium sized companies can more easily become large companies” (Clark and Christie, 2002).

Is New Zealand’s productivity growth impeded by obstacles to entrepreneurs? Is there a reluctance to set up new firms? Do firms that have shown some initial success face impediments to growth?
1. Firm Turnover and Productivity Growth

Creative destruction, Joseph Schumpeter famously said, “revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one” (Schumpeter, 1975, p. 82). The reallocation of resources from less productive activities to more productive ones via the rise and fall of firms is one of the main sources of any market economy’s dynamism. Setting up a firm is a kind of search process. Entrepreneurs learn by doing, as new firms experiment with new lines of business. Often the activity is not as profitable as hoped and the firm contracts or shuts down. Sometimes the market reveals the product to meet a demand and the entrepreneur to be a skilled manager, and the firm expands. The market process rewards the better firms and winnows out the weaker ones.

By simple arithmetic, there are two ways to improve an industry’s productivity: raising the productivity of each of the firms in the industry, or holding each firm’s productivity constant but increasing the market share of the more productive firms (or creating new, more productive firms) while decreasing the share of the less productive. There would be no need for market shares to change if best practice readily diffused across firms, but to a surprising extent such diffusion fails to occur. Empirical studies in the United States and elsewhere find interfirm productivity gaps to be wide and persistent (Bartelsman and Doms, 2000). In any given industry, output per worker can be twice as high or more in the better-performing firms than in the lesser ones, and those productivity laggards often continue as laggards for years. The skills of a firm’s workforce, the size and age of its capital stock and the talents of its managers affect its productivity (though
the existing econometric studies of the sources of productivity differences leave a large unexplained residual, so we do not have much understanding of why the differences are so persistent. It is because of these interfirm productivity differences that the turnover of firms measurably contributes to industry productivity. In the United States and Canada, about 50 percent of a typical industry’s productivity growth is attributable to firm turnover (Caves, 1998, pp. 1971-75; Haltiwanger, 2002).

One route to higher productivity is a better educated workforce and technological advance, which bring within-firm productivity gains. Another route, with roughly equal potential for boosting industry-level productivity according to the overseas data, is the creation, expansion and shrinkage of firms. In an economy in which firm turnover is blocked, unblocking it could potentially double overall productivity growth.

2. The Downside of Firm Turnover

While the chief effect of firm turnover is to increase the economy’s productivity by reallocating labour and capital to more productive uses, there are some caveats. More turnover is not necessarily better. For reasons to do with efficiency or distribution, the level of firm turnover could be too high.

The efficiency concern is that frictions in the labour market or the capital market could result in excessive job destruction. Because information does not flow perfectly freely in the labour market, job seekers and job vacancies coexist, as potentially productive matches between employers and employees fail to be realized. While the laid-off workers search for jobs, output and wages are lost. Firms have no incentive to take
these social costs into account when they make their lay-off decisions, and so too many workers might be laid-off (Howitt and McAfee, 1987). How the financial market works also matters. If a firm is capital-constrained, as small firms in particular often are, it may be unable to wait out a temporary drop in demand for its product, and so it lays off workers whom it would have kept had it been able to obtain a bank loan.

The distributional concern is that the burden of adjustment is borne by the workers who, though no fault of their own, are thrown out of work when their firms shrink. The severity of this burden is an empirical issue, depending on the duration of laid-off workers’ unemployment and the level of unemployment benefits. Even those not laid off suffer uncertainty about whether they will keep their job. However, the costs borne by the workers bear no simple relationship to the amount of job destruction, for across the economy the amount of job destruction is approximately equal to the amount of job creation (Davis et al., 1996; Gómez-Salvador et al., 2004). In those countries with rapid job destruction there is also rapid job creation, so workers, while laid off relatively frequently, face plentiful new job opportunities and short unemployment spells.

Conversely, countries that legislate against lay-offs reduce job destruction by fiat but also reduce job creation, thus hampering the entrepreneurs’ search for better lines of business and lowering the economy’s long-term growth.

Since job creation goes hand in hand with job destruction, workers are not necessarily better off where job destruction is lower. If the workers’ adjustment burden is judged to be too high, the appropriate policy response, arguably, is not to make it harder for firms to lay off employees but perhaps to address the distributional issue by increasing the level of unemployment benefits or to address the efficiency issue by
introducing policies to help those laid off get back into jobs, such as offering retraining opportunities, improving the matching process and lowering search costs.

Firm turnover, then, is simultaneously beneficial, in increasing productivity by shifting resources into their best uses, and harmful, in putting the burden of adjustment on the workers who lose their jobs. In what follows, I will not try to assess whether the current amount of firm turnover is optimal. Rather, I will try to test the claim that, as a result of business-unfriendly policies, there are is too little. Is creative destruction being held back?

3. Quantifying Creative Destruction

I will use ten criteria to measure the economy’s flexibility:

- regulatory impediments to setting up a firm and to expansion
- the amount of job creation and job destruction
- the turnover of wealth
- the accessibility of the business sector to people of any background
- gaps in the size distribution of firms
- the likelihood of transitioning from small to medium-sized
- the likelihood of downsizing
- the likelihood of becoming large
- hindrances to converting to share ownership
- changes in the list of the top ten corporations.
By tracking changes over time in these measures, policy-makers could get an informative
gauge of the economy’s health.

3.1 Regulatory impediments?

Is red tape a deterrent to starting up firms? In 2002, New Zealand had more than
240,000 firms with five or fewer employees (MED, 2003, p. 5). The sheer number
suggests that the red tape for setting up a firm is inconsequential. One out of nine adult
New Zealanders runs one of these tiny firms.

New Zealand’s regulatory costs of starting a business are among the world’s
lowest, according to Djankov et al. (2002), who described the country’s procedures for
registering a new firm as “streamlined.” It takes 3 days to begin operating legally in New
Zealand, compared with 2 days in Australia, 4 days in the United States and United
Kingdom, 42 days in Germany and 53 days in France. Licensing regulations can be very
damaging. Countries with high costs of setting up a firm have little entry, little job
creation and slow productivity growth (Johnson et al., 2002; Klapper et al., 2004).
However, the data offer no reason to be concerned about regulatory barriers to entry in
New Zealand.

Ongoing businesses face costs of complying with government regulations on
taxation, worker relations, health and safety, labeling and certification, resource
management etc. In a quarterly survey of small businesses run by the National Bank,
regulation is usually the most cited or second-most cited concern, with around 20 percent
of the respondents saying it is their biggest problem (National Bank, various dates). How
big, in fact, are compliance costs in New Zealand? They are low, according to one
survey of small firms (Alexander et al., 2004), averaging one hour per week of the manager’s time. They are high, according to another (KPMG, 2003), averaging five hours per week for firms with five or fewer employees and thirteen hours per week for firms with six to nine employees. Which is more accurate is an open question. (Neither is definitive: the Alexander et al. survey was more through but had a small sample, while KPMG relied questionably on the respondents’ memories.)

New Zealand’s red tape seems to be less burdensome than Australia’s. A survey by the OECD found compliance costs per employee to be 40 percent lower in New Zealand than Australia (OECD, 2001, p. 22), and a survey by the Auckland and New South Wales Chambers of Commerce found them to be 16 percent lower (Read, 2004).

Does red tape discourage firms from growing? As a firm’s workforce expands, according to the KPMG survey, compliance costs rise less than proportionately. Compliance costs fall most heavily on the smallest firms, therefore, which suggests that, if anything, they should serve as an incentive to expand. While red tape might perhaps induce an early exit from some firms, it could push others to grow.

Current or future policy changes could place new impediments in the way of entrepreneurs. In 2004, Roderick Deane expressed fears about a plethora of re-regulation, which he said will bring “reduced flexibility and reduced adaptability for private sector firms” (O’Sullivan, 2004). Managers everywhere grumble about red tape, however, just as farmers grumble about the weather. The way to assess fears of excessive regulation is not by anecdotes but by systematically tracking changes over time in firm turnover.
Some firms suffer higher compliance costs than others, as described in the periodic newspaper report on a firm hit hard by red tape. However, the data indicate that regulation is not a serious impediment for the typical New Zealand firm.

3.2 Job creation and destruction?

The primary measure of an economy’s flexibility is the amount of job creation and job destruction. In the United States, about 10 percent of all jobs are destroyed each year. Meanwhile, roughly as many are created anew (Davis et al., 1996; Haltiwanger, 2002). Job creation slightly exceeds job destruction some years, and the reverse in other years, with job destruction showing more cyclical variation than job creation. When you think about it, 10 percent of all jobs is an astonishingly big number. In the European Union, turnover is high but not as high in the United States, with 6 percent of jobs being created and destroyed each year. The rate varies from country to country: for example, in Germany it is 4 percent, in France, 5 percent, in the UK, 7 percent, and in Spain, 9 percent (Gómez-Salvador et al., 2004). More volatility is seen in small firms than in large, and more in services than in manufacturing.

In New Zealand, jobs were created at a rate of 18 percent each year between 1995 and 2001 and jobs were destroyed at a rate of 15 percent (Carroll et al., 2002). Another estimate, using data definitions more consistent with the European and United States studies, estimated the rate of job creation and destruction to be just under 12 percent (Mills and Timmins, 2004). New Zealand’s job creation and destruction is somewhat more rapid than in the United States and considerably more rapid than in Europe.
Less job destruction—and less job creation—occurs in those European countries with stricter job-protection legislation, a longer duration of unemployment benefits and more wage-setting coordination (Gómez-Salvador et al., 2004). By comparison with Europe, New Zealand’s high job turnover suggests that the labour market is not constrained by regulation. In its job creation and destruction, relative to other countries, the New Zealand economy exhibits a lot of flexibility.

3.3 Turnover of wealth?

Related to turnover of firms is turnover of wealth. A measure of an economy’s receptiveness to enterprising individuals is the source of rich people’s wealth, inherited or self-earned. How the rich got to be rich affects a nation’s economic performance, according to Morck et al. (2000). Adding up the wealth of each country’s US-dollar billionaires, self-made and inherited, and correlating the totals with economic growth, they found that in countries where self-made billionaire wealth is a larger fraction of GDP, per capita GDP grows faster. This is unsurprising, being consistent with the notion of wealth as an incentive for productive effort. More striking, they further found that in countries where inherited billionaire wealth is a larger fraction of GDP, per capita GDP grows slower. (They call this the “Canadian disease.”) A preponderance of inherited wealth might result from education being unattainable for the poor, or from financial markets malfunctioning so as to exclude those who are not already established, or from firms staying family-run because the managerial labour market cannot cope with a transition from founder to professional manager. Whatever the reason, entrenching the rich and their offspring is bad for economic growth.
Is the New Zealand business sector accessible to enterprising people regardless of their upbringing? If we take the source of rich people’s wealth, inherited versus self-earned, as a measure of accessibility, New Zealand looks to be in good shape. Using as the cutoff a net wealth of at least NZ$10 million, Hazledine and Siegfried (1997) calculated that 74 percent of New Zealand’s rich did not get their start in life from inherited wealth. This is a larger fraction of self-made rich people than in Australia, with 66 percent, Britain, with 61 percent, or the United States, with 59 percent (though a higher wealth cutoff is used for these other countries). If those in banking, brokerage, real estate, business services and personal services are excluded, leaving manufacturing, mining and construction, the ratio drops but is still high, at 63 percent.

New Zealand’s rich tend to be self-made. The belief that those from modest backgrounds can succeed by their own hard work, the creed of “strive and succeed” associated with the writer Horatio Alger, is central to the American self-image. It seems to be more a reality in New Zealand than in the United States.

3.4 Accessibility of the business sector?

A caveat on the business sector’s openness is that members of the various groups in society do not all have an equal chance of becoming entrepreneurs. In the 2001 census, 9.3 percent of males are classified as employers, compared with 4.4 percent of females, while 8.4 percent of Europeans are employers, compared with 3.1 percent of Maori (MED, 2003, pp. 25-26). A Pakeha male is more than twice as likely to be an entrepreneur than either a female or a Maori.
Given the assumption that innate entrepreneurial talent is equally distributed across gender and across race, these numbers suggest that the nation’s stock of talent is not being fully utilized, at some cost, probably, to overall productivity. Research into the causes and consequences of the discrepancies could usefully inform policy.

3.5 Gaps in the size distribution of firms?

The firm-size distribution in many countries, especially developing economies, shows a missing middle. There is a lot of employment in tiny firms and quite a lot in large firms but not much in mid-sized firms (Snodgrass and Biggs, 1996). The missing middle is a symptom of weak legal and regulatory institutions. Small firms can survive in an institution-free environment, by using personal networks and ongoing relationships to substitute for missing laws of contract and retained earnings and personal savings to make up for a lack of access to financial markets (McMillan and Woodruff, 2002). Large firms also can prosper without institutions, getting by instead by cultivating political favours. They got to be big in the first place, usually, through knowing the right people. Where the lack of institutions shows up is for small firms wishing to grow. Needing to make discrete investments, they can no longer rely on retained earnings, and may be unable to grow if the financial market is underdeveloped. A symptom of inadequate institutions, therefore, is relatively few mid-sized firms.

Even in industrialized countries, small firms tend to get their finance largely from retained earnings and trade credit (Petersen and Rajan, 1997). There is a “pecking order,” in which a firm exhausts its internal funds before it seeks external funds. An informational asymmetry—the entrepreneur knows the firm’s prospects better than a
bank does—puts a wedge between the value of internal funds and the cost of external funds (Myers and Majluf, 1984). If information sources are lacking and investment uncertainties are prevalent, banks may be reluctant to lend to small firms, preventing them from growing to medium size.

Is there a missing middle in the size distribution of New Zealand firms? The data say there is not. Table 1 shows the percentage of total private-sector employment by firm size, measured as number of employees. New Zealand has proportionately as much employment in firms with 20 to 99 employees as Australia and more than the United Kingdom and the United States. To judge by the distribution of firm sizes, New Zealand’s firms do not seem to be hampered from growing from small to mid-sized.

3.6 Barriers to transitioning from small to medium-sized?

Another way of asking whether firms that show initial success face undue barriers to growth is to compute the likelihood of transitioning from small to larger (using data in MED, 2003, pp. 5, 17-18). Among firms that had 5 or fewer employees in 1995, 6 percent had grown by 2002 to have 6 to 9 employees and another 2 percent to have 10 to 19, and another 0.5 percent to have more than 20. By a back-of-the-envelope calculation, the firms that in grew, in the seven years, from less than six employees to six or more created more than 150,000 new jobs.

Among firms that had 6 to 9 employees in 1995, 21 percent had grown by 2002 to have more than 9 employees and another 3 percent to have more than 20. Among firms with 10 to 19 employees in 1995, 19 percent had grown by 2002 to have 20 to 49 employees and another 2 percent to have 50 or more. Among firms with 20 to 49
employees in 1995, 12 percent had grown by 2002 to have 50 or more employees. On the face of it these numbers do not look low.

The average New Zealand firm still in business four years after its birth has 22 percent more employees than when it started, according to Mills and Timmins (2004). In the United States, firms show much faster growth, with the average surviving new firm doubling its employment in four years. However, new firms grow unusually quickly in the United States, and the New Zealand growth rates are similar to those in the United Kingdom and other OECD countries.

Promising small firms, it would appear, are able to attract the capital and other resources they need in order to grow to medium-sized.

3.7 Barriers to downsizing?

The flip side of the ability of successful firms to expand is the ability of unsuccessful firms to shrink, freeing their labour and capital for other uses. The data on firm transitions (MED, 2003, pp. 17-18) show downward as well as upward flexibility. Among firms with 10 to 19 employees in 1995, 30 percent had shrunk to less than 10 employees by 2002. Among firms with 20 to 49 employees in 1995, 28 percent had shrunk to less than 20 employees by 2002. Among firms with 50 to 99 employees in 1995, 29 percent had shrunk to less than 50 employees by 2002. Among firms with more than 100 employees in 1995, 14 percent had shrunk to 20 to 99 employees, and another 9 percent to less than 20 employees.

The market winnows out the weaker firms ruthlessly. In New Zealand, by 2 years after founding, 23 percent of new firms have exited; after 4 years, 52 percent have exited
(Mills and Timmins, 2004, p. 19). In other words, a startup firm’s chance of surviving beyond 4 years is a mere 50 percent. Fast as this attrition may appear, it is comparable to, and actually somewhat slower than, in the United States and in the OECD overall.

These data do not allow us to judge whether there is the right amount of downsizing, but they do at least suggest that there is no major barrier to downsizing.

3.8 Barriers to becoming large?

Are there impediments to medium-sized firms becoming large? More than mere growth, turning into a large firm entails metamorphosis. A large firm is qualitatively different from a small or medium-sized firm. Instead of being owned by an individual or a partnership, it (usually) has share ownership. Instead of all decisions being made by the owner-manager, there is delegation of decision-making down a managerial hierarchy. The organization is inherently much more complicated. Trust becomes needed. Owners must trust the top manager to pursue their interests, and the top manager must trust middle managers to make the right decisions. Finding good managers requires an effective managerial labour market. Sustaining an efficient level of trade in stocks requires financial markets to have reached a degree of sophistication.

The data on firm transitions suggest New Zealand firms face no blockage to getting beyond 100 employees. Among firms with 20 to 49 employees in 1995, 2 percent had grown by 2002 to over 100, and among firms with 50 to 99 employees, 22 percent had grown to over 100 (MED, 2003, p. 18). Each year about 70 firms, employing about 1 percent of the total workforce, grew from less than 100 employees to more than 100.
While there seems to be no barrier to passing the 100-employee mark, conceivably there is a glass ceiling to firm growth at some higher number of employees. (100 employees is a low cutoff for “large.”) Small and medium-sized firms seem to have been the focus of much of the policy analysis up to now. (Note for example the NZ Treasury’s report (2004, p. 71), which discusses the financial market only as it affects small firms, and Helen Clark’s statement, cited above, of the need to make it easier for small and medium-sized firms to grow.) The evidence on firm transitions cited above suggests, however, that the small-and-medium sector is in fact in reasonably good shape. Perhaps it is time to focus the policy analysis on New Zealand’s largest firms. Most of the data collection up to now has examined small and medium firms (for example, MED, 2003), so collecting more data on large firms could be useful. The question of whether large firms face institutional or policy impediments to growth and efficient operation warrants further empirical research.

How productive are New Zealand’s large firms? After reviewing the available evidence on the largest firms, Simmons (n.d., p. 19) concluded that they have been performing poorly, measured by value added or return on assets; he called this poor performance a “mystery.” In their ability to create shareholder value, according to Healy (2000), the largest firms have been “hugely disappointing,” which he attributed to agency costs and “a lack of focus on managing shareholder wealth on the part of management.”

The smallness of the New Zealand market could explain underperformance (Skilling, 2001). A firm may be condemned to producing below minimum efficient scale unless it exports to some larger markets. Among firms with an annual turnover of at least $30,000, just 4 percent are exporters. Just 10 percent of those exporters account for 95
percent of exports (Simmons, n.d., p. 12). There are economies of scale in exporting, arising from the costs of learning about foreign demand and the differing ways of doing business, which may inhibit firms from moving into exporting.

A second possible reason for large-firm underperformance is a lack of managerial talent, which might, however, be temporary. The skills asked of a top manager in the pre-1984 protectionist economy were distinct from those needed in a competitive global marketplace. In the old economy, success came from negotiating favours from the government. Knowing how to compete was not the issue, for the government sheltered its chosen firms from the inconveniences of competition. As the industrialist Alan Gibbs described it, “Every area of our economy was licensed and if you had a licence you were protected and no one could break into your market” (Russell, 1996, p.12). Nowadays, managers must be capable of plotting competitive strategies. For the new breed of manager to develop expertise and rise to the top could easily take a couple of decades, and this could explain why large firms have been slow to show post-reform gains.

A third possible reason for the large firms’ poor performance, to be considered next, is frictions in the financial market.

3.9 Financial-market frictions?

For shareholders, second-guessing managers’ decisions is not easy, for they lack information about the firm’s affairs. The informational asymmetries can cause lemons-market problems to arise (Ausubel, 1990; McMillan, 2002, Ch. 13). Fearing their money will be mismanaged, investors may become reluctant to buy stocks, with the result that the stock market is less active than it should be and firms may be unable to acquire the
capital they need to grow. In many countries, lax financial-market oversights allow controlling shareholders to expropriate minority shareholders (Johnson et al., 2000).

Financial-market rules and regulations help limit the distortions from the separation of ownership and control, thus protecting the property rights of minority shareholders. Countries that have effective financial markets rely on the oversight not only of the courts but also of a regulator like the US Securities and Exchange Commission. Even Alan Greenspan now concedes this point, by the way. In 1966, as a disciple of Ayn Rand, he believed regulation was uncalled for because “it is in the self-interest of every businessman to have a reputation for honest dealings.” Warning against the perils of regulation, he said, “In a free economy, the government may step in only when a fraud has been perpetrated … the only protection required is that of criminal law” (Greenspan, 1966). In 2002, after the scandals of Enron, WorldCom and the rest, he changed his mind, saying, “Our most recent experiences clearly indicate ... that adjustments to the existing structure of regulation ... are needed.” A regulatory agency supplements the courts because it offers “rule-making flexibility” (Greenspan, 2002).

In a 2002 article in the New Zealand Herald, Minister of Commerce Paul Swain attributed low economic growth to the government’s not doing enough. To get New Zealand back into the top half of the OECD, a “healthy, effectively regulated [stock] market, enjoying the confidence of investors and in line with international norms, will be critical.” In New Zealand, “securities laws do not work as effectively as they should. Our insider trading laws are lax and the institutions regulating the market do not have adequate power to ensure the laws are effectively implemented.”
If the rules governing the financial market are inadequate, shareholders’ property rights are unprotected, and so firms may be hindered from getting the finance they need to convert themselves from medium-sized to large. Are there gaps in New Zealand’s financial-market regulation? The evidence is mixed.

In a comparison of investor protections across the industrialized countries, La Porta et al. (2002) calculated, as a rough proxy for investor protections, an “index of antidirector rights,” reflecting the ease with which shareholders can vote for directors as well as the existence of grievance mechanisms for shareholders. This index (with a higher number representing stronger protections) scores the United States and the United Kingdom 5, Australia 4, France 3 and Germany 1. New Zealand’s score is 4. An OECD study of financial systems (Leahy et al., 2001) compiled a summary measure of investor protections, reflecting the effectiveness of disclosure rules and enforcement as well as shareholder and creditor rights. With a higher number meaning stronger protections, the United Kingdom scores 0.86, Australia 0.60, the United States 0.42, Germany 0.23 and France -0.61. New Zealand’s score is 0.66. It would be incorrect to conclude that New Zealand could not improve its rules; more research on the details of the current rules is doubtless warranted. By these measures, though, in the 1990s New Zealand was protecting its investors as stringently as most of the other industrialized countries.

On the other hand, some measures suggest that all is not well in the financial market. One is the ownership of large firms. New Zealand’s companies tend not to be widely held. Looking at the 20 largest publicly traded firms in industrialized countries, and defining “widely held” to mean no single shareholder has more than 20 percent of the voting rights, La Porta et al (1999, p. 492) calculated that in the United Kingdom 100
percent of the largest companies are widely held, in the United States 80 percent, in Australia 65 percent, in France 60 percent and in Germany 50 percent. In New Zealand, by contrast, just 30 percent of the largest companies are widely held. Examining family ownership, again using the 20 percent cutoff for control, they found that in the United Kingdom none of the 20 largest companies is family controlled, in Australia 5 percent, in Germany 10 percent, in France 20 percent and in the United States 20 percent. In New Zealand, 25 percent of the 20 largest companies are family controlled.

A further indication that trade in stocks is not as active as it might be is in stock-market capitalization. The total capitalization of the New Zealand Exchange is about US$45 billion, less than that of many individual corporations overseas. (For comparison, the New York Stock Exchange’s tenth-largest company, Procter and Gamble, has a market capitalization of about $130 billion.) In 2002, according to the World Federation of Exchanges, market capitalization in New Zealand was 32 percent of GDP. While this is similar to Germany and France, it is far lower than in Australia, 92 percent, the United States, 105 percent, or the United Kingdom, 111 percent. Relative to the economy, the UK, US and Australian stock markets are three times as large as New Zealand’s.

Further research is warranted on firms’ propensity not to convert themselves to share ownership and, among those that do convert, to have concentrated ownership.

3.10 Changes in the top ten corporations?

Turnover in the list of a country’s largest corporations is related to economic performance, according to data in He et al. (2003). With initial per capita GDP,
education level and capital stock held constant, economic growth is faster in countries with more turnover among the top ten corporations. Greater instability among the largest corporations is associated with faster productivity growth and more investment. The economy performs well where new firms able to rise to the top; it performs badly where established firms are entrenched. The causality could go either way. Fast-growing firms could drive economic growth; or the inability of new firms to rise to challenge the established corporations might be a symptom of deeper market rigidities. Turnover matters for growth, then, at the level of not only the smallest firms but also of the largest.

Are there barriers to reaching the top of the New Zealand corporate sector? One piece of evidence, in Table 2, suggests not. Between 1975 and 1996, New Zealand had more turnover in the list of its ten largest corporations, and less continuity of control, than Australia, France, Germany and the United States, and almost as much as the United Kingdom. A caveat: since the period includes the deep deregulation and privatization of the 1980s, these data may overstate the current amount of fluidity. Nevertheless, New Zealand has seen considerable turnover at the heights of the corporate world.

4. Markets Are Doing Their Job

To achieve economic growth, to repeat the passage already quoted from the Treasury report, “the business environment must be one where the incentives encourage enterprise and innovation, where firms seek out and develop profitable new opportunities, and where well performing and more productive firms will prosper, while poorer performers exit.” The evidence on firm turnover shows that these conditions already
characterize New Zealand. Contrary to the perception of an economy held back by business-unfriendly policies, New Zealand has plenty of creative destruction.

The data depict a nation in which enterprise flourishes. One in nine adult New Zealanders runs a firm with five or fewer employees. Barriers to entry being low, new firms start up at a rapid clip. Entrepreneurs are able to succeed by their own efforts, without having to rely on inherited wealth (though females and Maori are less likely to become entrepreneurs than white males). In each year, many firms disappear and many grow. There seem to be no major barriers to growth or shrinkage, so those firms that are revealed to have poor prospects are able to shrink or shut down, while those that have a marketable product and are well managed are able to expand. For large firms the evidence is less clearcut, and further empirical research is needed on their apparently limp performance. (Is it the financial market? The managerial labour market? Geography?) The list of the ten largest firms does, at least, show flux. One of the most fundamental of all market processes, the ebb and flow of firms in New Zealand seems to be unrestrained.

As the saying goes, “If it aint broke, don’t fix it.” Although for the largest firms there is a question mark, for small and medium-sized firms the evidence on firm turnover, to my reading, calls for neither more government action nor less. By and large, New Zealand’s labour market and financial market seem to be doing their job.
References


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Table 1: Employment by Firm Size

<table>
<thead>
<tr>
<th>Country</th>
<th>0 – 19</th>
<th>20 – 99</th>
<th>≥ 100</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Zealand</td>
<td>42%</td>
<td>19%</td>
<td>39%</td>
</tr>
<tr>
<td>Australia</td>
<td>47%</td>
<td>19%</td>
<td>34%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>30%</td>
<td>12%</td>
<td>58%</td>
</tr>
<tr>
<td>United States</td>
<td>28%</td>
<td>16%</td>
<td>56%</td>
</tr>
</tbody>
</table>

Source: Ministry of Economic Development (2003, p. 27)

Table 2: Corporate Stability

<table>
<thead>
<tr>
<th>Country</th>
<th>Corporate Stability</th>
<th>Control Continuity</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>20%</td>
<td>0%</td>
</tr>
<tr>
<td>New Zealand</td>
<td>30%</td>
<td>0%</td>
</tr>
<tr>
<td>France</td>
<td>40%</td>
<td>20%</td>
</tr>
<tr>
<td>United States</td>
<td>50%</td>
<td>0%</td>
</tr>
<tr>
<td>Australia</td>
<td>50%</td>
<td>10%</td>
</tr>
<tr>
<td>Germany</td>
<td>70%</td>
<td>30%</td>
</tr>
</tbody>
</table>

Corporate stability = fraction of top ten firms in 1975, by employment, that were still in the top ten in 1996.
Control continuity = fraction of the top ten 1975 firms that were still controlled by the same individual or family in 1996.

Source: He, Morck, and Yeung (2003).