VERITAS

A JOURNAL OF PUBLIC POLICY IN TEXAS

September 2004

Texas Public Policy Foundation
15th Anniversary

The Policy Primer Series

As lawmakers prepare for the 79th Session of the Texas Legislature in January, they will be facing issues of great economic and social importance.

The Texas Public Policy Foundation is proud to present the Policy Primer Series — a three half-day seminars addressing key issues. Partnering with the Foundation is the Texas Conservative Coalition Research Institute.

The first Primer will be held October 21, and focus on tax issues. Already confirmed to keynote the dinner is Colorado Governor Bill Owens! Preceding dinner will be two important panels with such participants as Ways and Means Committee Chairman Brian McCall, and State Representative Carl Isett.

The second Primer will be November 18, examining private property rights and key land use issues that will be debated in 2005.

The third Primer will be on December 10, highlighting the role Medicaid and other health care programs have in driving up the state's budget. Already slated to keynote this dinner is Club For Growth founder Stephen Moore!

Learn more online at www.TexasPolicy.com!

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Welcome To Veritas

While everyone is settling in for the Fall campaign season, the Texas Public Policy Foundation is looking two months past, to the start of the 79th Session of the Texas Legislature.

Not only will legislators have to again look closely at how best to live within the taxpayers means in determining a new state budget, but they will be forced to ask critical questions about the best role for government to play in our lives.

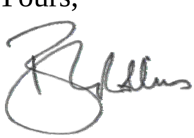
Of course, at the Foundation we seek a culture which is unfettered by the weight of government bureaucracy, where all individuals have the liberty to explore their God-given talents in the limitless marketplace of freedom. A tall order for a single legislative session? Absolutely! But a worthy goal for the lifetime of a generation.

In these pages, we scratch the surface of some new ways of looking at old problems. Whether you are interested in water availability or individual economic opportunities, the best answer is inevitably found in the free market.

We proudly continue our work providing Texas' leading policymakers with the “intellectual ammunition for a better Texas.” However, the battle in Texas rages on -- feel confident that the Texas Public Policy Foundation will remain at the forefront of that battle. It has been said “eternal vigilance is the price of liberty.” Your support for the work of the Texas Public Policy Foundation is, in a sense, the modern form of eternal vigilance. Thank you

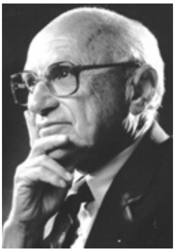
I hope you enjoy this issue of Veritas!

Yours,



Brooke Rollins
President, Texas Public Policy Foundation

What Others Say About The Texas Public Policy Foundation...



"I commend the Texas Public Policy Foundation for its excellent work in support of personal liberty and free markets."

– Milton Friedman, Ph.D.
Nobel Prize, Economics

"The Texas Public Policy Foundation is intellectually honest and driven by a desire to improve Texas for all Texans."

– The Honorable Tom Craddick
Speaker of the Texas House of Representatives

"More than a think tank for Texas, the Texas Public Policy Foundation is setting the standard by which other research organizations in the nation will be judged."

– John Fund
Wall Street Journal Editorial Writer

Salty Solution to Texas' Water Wars

***Steven A. Carr** is a Texas businessman and senior lecturer at Texas A&M University. He serves on several corporate boards of directors including two international water companies and is a member of the American Water Works Association.*

Situation

Texans have debated and fought over the State's water resources for decades. Water has been the foundation of business fortunes and failures. A reliable source of clean water is essential to the commercial attractiveness of the State and the economic prosperity of all Texans. Yet, according to the Texas Parks and Wildlife Department's senior director for aquatic resources, Dr. Larry McKinney, with Texas' population expected to double by 2050, almost 900 Texas cities will not have enough water from current sources to meet their needs. Estimates are that more than 120 of Texas' 281 major springs have dried up and, in 2001, the Rio Grande, the third longest river system in the United States, was so callously abused that her last trickle of toxic sludge never reached the Gulf.

The U.S. population grew 3.5 times from 1900 to 1995, yet water consumption grew 10 times during that same period. As our economy expands, we will continue to demand greater amounts of water per capita for recreational, commercial, industrial and personal use.

When the general public thinks of water, we tend to think in terms of essential consumer uses such as personal hygiene, cooking, cleaning and watering our lawns. However, such usage accounts for less than 11% of total water consumption; 41% is used for agriculture, 40% for thermoelectric and 8% for industrial. For example, 2,800 to 3,200 gallons of "ultra-pure" water are needed to produce a single eight-inch silicon wafer for semiconductor manufacturing; 50,000 gallons are needed for the average rayon living room carpet; and 40,000 gallons are used to manufacture the steel components in one automobile. [*Adams, Harkness & Hill*]

Texas cannot wait, nor can Texans expect to solve our water shortage problem with tax dollars alone. Construction of dams and reservoirs can take decades, cost billions of dollars, and drown habitats. The Texas Water Development Board estimates it would take $25 million in public funds to determine whether there is enough water in West Texas aquifers to allow pumping for commercial sale. Such proposals have been almost universally condemned by area farmers and ranchers who say the drought-parched land can barely sustain current demand. [*Associated Press*]

Salty Solution

The good news, however, is that Texas is blessed with more than 400 miles of coastline and an unlimited supply of seawater. Recognizing such limitless potential, in April 2002, Governor Rick Perry announced an initiative to develop a seawater desalination project in Texas and has said that Texas should be a national seawater desalination leader. In order to continue to provide an essentially inexhaustible supply of potable (drinkable) water without depleting our valuable natural wetlands and aquifers, Texas must consider desalination of seawater as an essential component of any water initiative.

Seawater is a solution of salts (primarily Chloride: 55%, Sodium: 31% and Sulphate: 8%), of nearly constant composition for billions of years. Desalination is the conversion of seawater to potable water. There are three primary forms of desalination, however, reverse osmosis (RO) is the most effective and efficient conversion process, and the only way to produce the ultra-pure water essential in a variety of growing industries such as the semiconductor, pharmaceutical and electronic display markets. RO requires no dams or reservoirs, is drought proof, unaffected by local hydrological activity, and circumvents water rights disputes and the destruction of habitats.

However, seawater RO operations are technically complex, security sensitive and capital intensive. In fact, the water industry is the most capital intensive of all public utilities with more capital invested per dollar of revenue than either electric or gas utilities. In a report to Congress in February 2001, the EPA estimated that the nation’s water systems must invest a minimum of $141 billion by 2018 just to meet the requirements of the Safe Drinking Water Act of 1974.

Yet, dollars are only one of two great hurdles in the design and operation of potable water systems. Seawater reverse osmosis (SWRO) filtration plants are intensely scientifically intricate. Design engineering on feed water analysis, pre-treatment components to remove suspended particles, precipitation inhibitors, energy recovery systems, degasifiers, scrubbers and post-treatment aesthetics must be performed by professional engineers with extensive SWRO operations experience or any such venture is doomed.

One need only examine the Tampa Bay project to appreciate the inherent dangers with large-scale desalination design and operations projects. Various problems, including pre-filtration and a flawed plant design have caused the filters to foul and idle the $100 million, 25-million-gallons-per-day SWRO desalination plant built more than a year ago and estimates to fix the plant are in the range of $29 million. [*PWFinancing, April 2004. Water Desalination Report, August 12, 2004*]

Public-Private Partnerships

Public-Private Partnerships (PPP) can avoid similar disasters in Texas. There are two advantages to PPPs: 1) they transfer risk from taxpayers to private companies and 2) they provide access to private capital. For example, working with the State, a private operator is able to finance some capital expenditures with tax-exempt bonds or private activity bonds rather than relying solely on tax dollars. New York's JFK Air Terminal was financed with such bonds. The terminal redevelopment project used a Vertically Integrated Project model that consisted of the design, construction and operation (DBO) of the $1.2 billion, 1.5 million square foot terminal. The project took four years to complete and experts estimate that if the New York Port Authority had attempted the project without the PPP it could have taken 15 years or more. [*Lehman Brothers, August 2004]*

Aqua America, Inc. originated a regulatory benefit known as Distribution Service Investment Charge (DSIC), which allows companies to put into their rate base any finished item – plant or equipment – that is a replacement for an existing rate base item. These items can then earn the current allowed rate of return subject to ultimate regulatory review.

Regulatory agencies and investor-owned operators may negotiate rate base adjustments for energy costs, which are 40% of the production expense. Municipal power station cooling water can be blended with the seawater thereby further reducing costs (the warmer the water, the less energy is required). Water authorities and private operators can agree on a Modular Unit Sequencing plant design, which allows the plant to grow as the demand grows without sinking capital into excess capacity. These and other public/private cooperative strategies can bring the cost-per-thousand-gallons of RO water to within reasonable range of existing surface and groundwater sources, which have no ability to expand with growing demand. In fact, with such partnerships and constantly improving technology, the cost of SWRO water has declined from $6.00 per thousand gallons (Santa Barbara, 1991) to less than $2.00 per thousand gallons (Singapore, 2003). [*T. Pankratz, CH2M Hill, August 2004*]

Vertical Integration Models

Texas regulators should be encouraged to use the Vertically Integrated Project model used by municipalities to provide other public facilities such as hospitals, highways, buildings and bridges. Using some form of the Design, Build, Own, Operate, Transfer (DBOOT) model, the municipality does not need to spend the tens of millions of dollars required to own the plant from the outset. With this model, competitors would be bidding for a finished product rather than separate stages and components of the finished product. It also eliminates any possibility of the component contractors blaming each other if there is an operating problem down the road, which could result in an idle plant and protracted litigation. This is what happened at Tampa Bay.

The DBOOT, DBO, or some other vertically integrated project model also affords the municipality an extended warranty period (as long as the operating contract) during which time the contractor is solely responsible for the design, maintenance and final product cost. At the end of the operating contract, the contractor turns over a water plant to the customer that meets all performance criteria, has all the "bugs" worked out, and has a proven production track record. The most sensible, cost-effective model for Texas is for the municipality to simply buy the water, at a specified quality and quantity, from an experienced operator who has personally designed and maintained the plant to work properly. This model is currently used in dozens of municipal systems around the world and gives the municipality a very easy way to measure whether the contractor is performing.

The central question in evaluating any bid proposal submitted by a DBOOT water company then becomes simply, "Does the operator have the technical and financial ability to supply the municipality with potable water in the quantity, quality and at the price proposed by the operator's bid?" It is the company's responsibility to demonstrate, to the regulatory authority's satisfaction, that it has the operational experience to deliver the quantity of water, with the chemical specifications, within the timeframe and at the cost outlined in its proposal.

It is not too late to solve our state's inevitable water crisis. With properly designed SWRO facilities, operated by SWRO-experienced, investor-owned companies, Texans have access to all the clean water we could ever want. However, the expense and expertise required demands we begin now to enact legislation that will enable municipalities and water authorities to partner with such companies through Public-Private Partnerships. Only then will we secure an abundant supply of pure, clean water that future generations of Texans will need for personal enjoyment and economic prosperity.

No More Tax Heroin

Federal Action Could Restore Sales Tax Deductibility

Byron Schlomach, Ph.D., *is the chief economist for the Texas Public Policy Foundation.*

Finally the folks in Washington are doing something to help Texas. For those who believe in limited government and personal liberty, the most horrifying development of the May special session on school finance was talk of instituting some type of income tax.

This makes all the more welcome the news that our federal representatives are a big step closer to once again making state and local sales taxes deductible on the federal income tax.

State income taxes and their close cousins, various so-called “business” taxes such as the gross receipts tax, payroll tax, and business activity tax, can be deducted from the federal income tax. Texas’ biggest state tax, the sales tax, is not currently federally deductible.

The only tax a large number of Texans can deduct is the property tax. However, this is the tax that everyone agrees is too high. The problem with reducing property taxes, though, is some other tax will have to be created or raised.

Most economists agree consumption taxes – like the sales tax – least harm an economy. Taxing goods and services purchased by the final consumer avoids taxing the same thing repeatedly, it does not discourage work, and actually encourages saving.

A big impediment for the last 18 years to shifting from property to sales taxes has been the lack of federal tax deductibility for sales taxes.

HR 4520, currently in conference negotiations, could once again make sales tax deductibility a reality. However, since sales tax deductibility is not in the Senate version, House conferees must stand firm in order to send this long-overdue reform to the president for his signature.

President Bush has signaled his strong support for such a move.

It was estimated by Texas' Comptroller's office that for every dollar shifted from the property tax to the sales tax, Texans would lose 14 cents in federal income tax deduction. A $2 billion shift from the property tax to the sales tax would have directly cost Texas taxpayers $280 million dollars – more in economic terms.

In 2003, over $14 billion of all state tax revenues were collected through the state sales tax. That means Texans lost almost $2 billion in federal income tax deductions that ought to be ours since, along with only eight other states, we have no income tax. For this reason, some in the Texas legislature felt compelled to recommend some type of deductible income-type tax to replace property taxes.

Current federal tax policy forces states to adopt an income tax. Income taxes admittedly have some great characteristics. The personal income tax, gross receipts tax, business activity tax, and payroll tax all tax broadly and can raise a lot of money at a very low rate.

But heroin has a lot of desirable characteristics, too. So many wonderful uses did heroin have when it was discovered, it was considered "heroic" and thus its name: "hero-in." Only later was its dangerous addictive quality realized.

Similarly, income taxes are addictive and dangerous.

Ohio was once like Texas. Three decades ago it had a thriving economy with the nation's third lowest tax burden. Then, Ohio's politicians imposed an income tax, with the federal tax code giving them cover. That cover may have shielded the politicians, but it left the economy very cold.

Today, Ohio has the third highest tax burden. It leads the nation in the number of individuals in their prime earning years leaving for work in other states.

It has only been since 1986 that the state and local sales tax has not been deductible. That mistake has long needed correcting.

It is time the federal government stopped encouraging states to dig their own economic graves. It's up to the U.S. Senate to help states put away their shovels.

SAVE THE DATE!

This exciting event brings together lawmakers, policy experts, opinion leaders and interested Texans to talk about the pressing policy issues facing the Legislature.

This year, panel discussions will include

- ✯ health care
- ✯ education
- ✯ taxes
- ✯ telecommunications
- ✯ tort reform
- ✯ and much more!

This has been a sell-out, standing-room-only event each year – so make sure you get registered early!

Registration information will be available soon at www.TexasPolicy.com!

How Much Worse Off Are We?

Arnold Kling, Ph.D., *is a contributing editor to Tech Central Station. He was an economist with the Federal Reserve Board and later with Freddie Mac.*

"…millions of low wage American workers are earning less in real, inflation-accounted for dollars today than they earned in the 1970s."
– Vermont Congressman Bernie Sanders

Today, there are two Americas. One America agrees with Congressman Sanders and Senator John Edwards that life is getting harder for working Americans, that things have been going down hill for thirty years, and that our only hope is bigger government. The other America realizes that it is nonsense to suggest that the middle class is disappearing and that the standard of living is eroding for working Americans.

This essay consists mostly of a deluge of statistics. But before I get to that, let me just ask you to consider what you can see with your own eyes. Is your family worse off than it was in the 1970's? Are many of the families that you know worse off? Do the people that you see in shopping malls, on vacation, on the highway, or in restaurants look like they are worse off than they were thirty years ago?

In the 1970's, ordinary working people drove Vegas and Pintos. They did not eat out much. They rarely traveled by airplane. Many of their jobs were dangerous. Do you really think that there are many working Americans today who would trade places with their 1970's counterparts?

The Disappearing Lower Class

What disappeared between 1970 and today was not the middle class but the lower class. The table below shows the percentage of households without certain basic middle-class necessities in 1970 vs. today.

Item	Percent Lacking in 1970[1]	Percent Lacking Now[2,3]
telephone	13.0 %	2.4 %
complete plumbing	6.9 %	0.6 %
refrigerator	17 %	0.1 %
Stove	13 %	0.3 %
color television	66.0 %	1.1 %
Vehicle	20.4 %	10.3 %

Today, 68.6 percent of households own their own homes. This is an all-time record, four percentage points higher than in the 1970's.

Next, consider some items that would have been viewed as luxuries in 1970. The table below compares the prevalence of these goods in the *average household* in 1970 with their prevalence in 2001 in households with incomes *less than $15,000*.

Item	Percent of *All* Households Owning in 1970[1]	Percent of *Poor* Households Owning in 2001 [3]
Dishwasher	26 %	18 %
Clothes Washer	62 %	57 %
Clothes Dryer	45 %	45 %
Cell Phone	0 %	23 %
Large-screen TV	0 %	25 %
Answering Machine	0 %	37 %
Cable or Satellite TV hookup	0 %	64 %
VCR	0 %	74 %
Microwave Oven	0 %	75 %

Economic historian and Nobel Laureate Robert Fogel considers statistics like these and concludes[4] (p.71):

> "Indeed, we have become so rich that we are approaching saturation in the consumption not only of necessities, but also of goods recently thought to be luxuries...Virtually everyone who is old enough and well enough to drive a car has one. In the case of television, there are 0.8 sets per person (2.2 per household)...The level of saturation for many consumer durables is so high that even the poorest fifth of households are well endowed with them."

Given these statistics, what explains the fact that, adjusted for inflation, the pay of the lowest-wage workers has not increased much over the past thirty years? There are a number of factors involved, but I suspect that the largest component of the explanation is a shift in the composition of the low-wage work force. In the 1970's, many of the people at the bottom of the wage scale were heads of households. Today, many low-wage workers are providing second or third incomes to families.

The important point to bear in mind is that "the bottom fifth of the wage distribution" does not represent some permanent group of people. Instead, it signifies the earnings of workers who *at that time* have the lowest levels of skills and experience. My college-age daughters, doing temporary clerical work, are in the bottom fifth. But even if the income of the bottom fifth were to stagnate over the next twenty years, my daughters will earn higher incomes as they acquire valuable knowledge.

The Long View

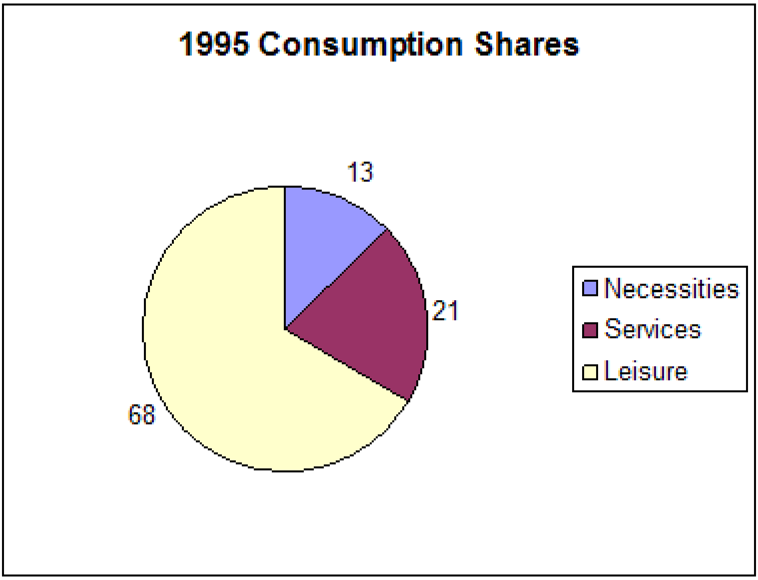
Fogel tracks economic progress over long periods. One of the most important trends of the past century is the reduction in the average work week. Contrary to another popular myth, Americans are working *much less* than they used to. Fogel writes[4] (p. 66):

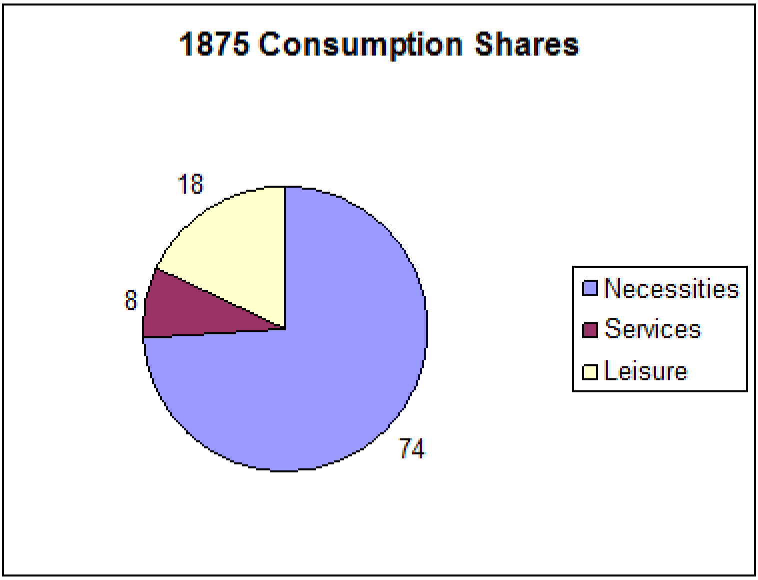
> "in 1890, retirement was a rare phenomenon. Virtually all workers died while still in the labor force. Today, half of

those in the labor force, supported by generous pensions, retire in their fifties."

Furthermore, Americans work many fewer days than they did a century ago. Using as a benchmark a 365 day work-year, Fogel calculates[4] (p. 68) that in 1880 on average male household head worked 8.5 hours per day, but only 4.7 hours per day in 1995. With less time spent working and somewhat better health, total leisure available has more than tripled, from 1.8 hours per day to 5.8 hours per day.

Fogel's most interesting table[4] (p. 89) is abbreviated and put into a chart format below. Fogel folds leisure into total consumption and then compares the shares of consumption in 1875 and 1995.





In 1875, roughly 3/4 of consumption was on basic necessities -- food (49 percent), clothing (12 percent) and housing plus consumer durables (12 percent). By 1995, these necessities accounted for only 13 percent of consumption. Able to acquire the basic necessities with less than one-third of the labor formerly required[4] (p. 72), households have dramatically increased leisure. In addition, the share of consumption of services has gone up, including education (from 1 percent in 1875 to 5 percent in 1995) and health care (from 1 percent to 9 percent).

We Are Healthier

The increased share of spending on health care is often given a negative spin by journalists and politicians. We hear that "health care is too expensive."

In some ways, my personal experience typifies the trend in expenditures. Our family is spending much more on health care than my parents did thirty years ago.

On the other hand, I am reluctant to conclude that health care has become too expensive. My wife's cancer was detected early and treated effectively. My mother's cancer killed her in 1976, at age 53. If you ask me, the 1970's were no golden age of medical care.

Fogel's data supports the view that our health is improving. Again, taking the long view, he writes[4] (p. 21):

> "technopysio evolution...has enabled *Home Sapiens* to increase its average body size by over 50 percent and its average longevity by more than 100 percent since 1800."

Quality of life is improving at least as dramatically as longevity. Fogel reports[4] (p. 91) that the average number of chronic conditions per U.S. male aged 60-64 fell from 5.6 in 1900 to 1.6 in the mid 1990's. This represents an average annual drop of 1.3 percent. The rate of decline reached 1.7 percent per year from 1982-1999, and Fogel notes[4] (p. 84) that some evidence suggests that even within that timespan the improvement was greatest in the most recent years.

The reality is that neither the rise in health care expenditures nor the standard of living of working Americans represents a problem. The false portrayal of these issues by the Left is more likely to provoke a crisis than to solve one.

Sources

[1] *W. Michael Cox and Richard Alm, Myths of Rich & Poor.*
[2] *Census Data Sample in 2000.*
[3] *Department of Energy Appliance Survey in 2001.*
[4] *Robert William Fogel, The Escape from Hunger and Premature Death, 1700-2100.*

Rolling Back Government

Maurice P. McTigue, Q.S.O., *was a member of the New Zealand Parliament and New Zealand's ambassador to Canada, and was closely involved in New Zealand's deregulation of labor markets, deregulation of the transportation industry, and restructuring of the fishing industry through the creation of conservation incentives. He is a distinguished visiting scholar at the Mercatus Center at George Mason University, and a senior fellow at the Texas Public Policy Foundation.*

The following is adapted from a lecture delivered February 11, 2004, at Hillsdale College, during a seminar on "The Conditions of Free-Market Capitalism," co-sponsored by the Center for Constructive Alternatives and the Ludwig von Mises Lecture Series. Reprinted by permission from IMPRIMIS, the monthly journal of Hillsdale College (www.hillsdale.edu).

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

What we're seeing around the world at the moment is what I would call a silent revolution, reflected in a change in how people view government accountability. The old idea of accountability simply held that government should spend money in accordance with appropriations. The new accountability is based on asking, "What did we get in public benefits as a result of the expenditure of money?"

This is a question that has always been asked in business, but has not been the norm for governments. And those governments today that are struggling valiantly with this question are showing quite extraordinary results. This was certainly the basis of the successful reforms in my own country of New Zealand.

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

Spending and Taxes

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

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

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

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

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

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

Subsidies, Education, and Competitiveness

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

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

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

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

It cost us twice as much to get a poorer result than we did 20 years previously with much less money. So we decided to rethink what we were doing here as well. The first thing we did was to identify where the dollars were going that we were pouring into education. We hired international consultants (because we didn't trust our own departments to do it), and they reported that for every dollar we were spending on education, 70 cents was being swallowed up by administration. Once we heard this, we immediately eliminated all of the Boards of Education in the country. Every single school came under the control of a board of trustees elected by the parents of the children at that school, and by nobody else. We gave schools a block of money based on the number of students that went to them, with no strings attached. At the same time, we told the parents that they had an absolute right to choose where their children would go to school. It is absolutely obnoxious to me that anybody would tell parents that they must send their children to a bad school. We converted 4,500 schools to this new system all on the same day.

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

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

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

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

Thinking Differently About Government

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

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

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

This law orders government departments to identify in a strategic plan what it is that they intend to achieve, and to report each year what they actually did achieve in terms of public benefits. Following on this, two years ago President Bush brought to the table something called the President's Management Agenda, which sifts through the information in these reports and decides how to respond. These mechanisms are promising if they are used properly. Consider this: There are currently 178 federal programs designed to help people get back to work. They cost $8.4 billion, and 2.4 million people are employed as a result of them. But if we took the most effective three programs out of those 178 and put the $8.4 billion into them alone, the result would likely be that 14.7 million people would find jobs. The status quo costs America over 11 million jobs. The kind of new thinking I am talking about would build into the system a consequence for the administrator who is responsible for this failure of sound stewardship of taxpayer dollars. It is in this direction that the government needs to move.

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