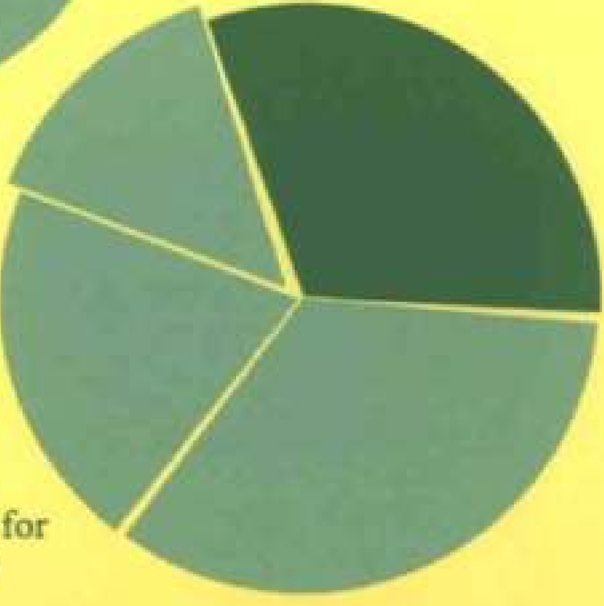
ROGERNOMICS

Reshaping New Zealand's Economy



Edited by

Simon Walker
Executive Director
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Independent Studies

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PREFACE

Between 1984 and 1988, the Fourth Labour Government undertook the most comprehensive and far-reaching revisions of economic policy that New Zealand had ever experienced.

Gone was the fortress mentality which for decades had encouraged import substitution. Financial markets were deregulated, the New Zealand dollar was floated, wage and price controls were scrapped. Subsidies were abolished, the tax system upended and government departments restructed in a way which had been regarded as politically impossible. State-owned enterprise moved steadily towards privatisation.

The process became known as "Rogernomics" after Finance Minister Roger Douglas, the driving force behind the reforms. Deregulation was not simply a Labour Party cause: many National MPs had pushed against the *dirigisme* of Sir Robert Muldoon.

Yet there were important aspects in which the administration did not apply free-market principles. Government spending grew substantially, and the labour market stood out against the tide of deregulation.

At the end of 1988, the government consensus which promoted Douglas's reforms came apart. This book was being completed as Roger Douglas left the Government and before the impact of his dismissal became apparent. By February 1989, both New Zealand political parties were divided over the appropriate level of government involvement in the economy.

Nonetheless, as Opposition MP Simon Upton notes in his critical perspective in this book, the centre of gravity in New Zealand's economic debate has shifted irrevocably.

Rogernomics: Reshaping New Zealand's Economy is an account of sectoral changes in New Zealand economic policy by individuals, many of whom have been participants in the process of change. One field of policy has been largely set aside. Although a Royal Commission on Social Policy mulled over welfare issues for much of the era of Rogernomics, the administration's intentions seemed so uncertain that I felt little purpose would be served by speculating loosely in this book. Several authors deal with the fiscal consequences of the Labour Government's failure to address social policy issues.

It would have been impossible to blend personal style and interpretation into a seamless analysis of events or to eliminate inevitable and sometimes substantial differences of opinion. I have not tried to do so. Rather, these essays are presented as ten individual assessments of the reform process, its achievements and inadequacies. Like all NZCIS-generated publications, it is intended to stimulate debate rather than present a definitive verdict on what is, after all, a continuing process.

I am grateful to Hanne Hulme, formerly Assistant Director of NZCIS, who initiated this project, and to the Centre's chairman and trustees who have made its publication possible. My particular thanks to those who have contributed their views.

Simon Walker
March 1989

CONTRIBUTORS

COLIN JAMES is one of New Zealand's foremost political commentators. He is a former editor of *National Business Review*.

ROGER DOUGLAS was New Zealand's Minister of Finance until December 1988. He has been an MP since 1969 and is the author of *Towards Prosperity* and *There's Got To Be A Better Way*.

SIMON UPTON is National Party spokesperson on social welfare. He was awarded a Rhodes scholarship and has been an MP since 1981. He is author of *The Withering of the State*.

GRANT SPENCER is Chief Economic Manager at the Reserve Bank. DAVID CAREY is advisor to the Reserve Bank's economic department.

RODERICK DEANE is Chief Executive of Electricorp. He was Chairman of the State Services Commission while much government sector restructuring was being undertaken. He was formerly Deputy Governor of the Reserve Bank.

IAN DICKSON is a financial analyst for Fay Richwhite and Company who has recently completed a secondment to the Minister of Finance. He was formerly a Treasury officer and was closely involved with the introduction of GST.

BRYCE WILKINSON is Head of Research for Jarden Morgan, one of New Zealand's leading stockbrokers. He was formerly a Treasury officer.

DAVID GALT is Director of Economics at the Department of Trade and Industry.

PENELOPE BROOK is Executive Assistant at the New Zealand Business Roundtable.

SIMON WALKER was Executive Director of the New Zealand Centre for Independent Studies. He is a journalist, and has been director of research and director of communications for the Labour Party.

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OVERVIEW

Colin James

IN FEBRUARY AND MARCH 1979 the grassroots of the National Party rebelled. At branch and constituency annual meetings a torrent of resolutions poured forth demanding a return by its Government to market-oriented policies, a smaller state, lower taxes and a reduction of union power. That was what many in the party thought they had worked for in returning National to power in 1975 with Sir Robert Muldoon as Prime Minister. Instead, after some liberalisation of the financial sector and some cuts in state spending in early 1976, Muldoon resorted enthusiastically to the state's armoury, even intervening in early 1978 in the vital meat processing industry to pay out of state coffers some of what the striking workers were demanding. In the election in November of that year the National Party won fewer votes than Labour and remained in office only by the quirks of the electoral system. Muldoon got the blame. Resentment and frustration boiled over.

In 1987 the Labour Party rebelled against a just re-elected Cabinet which had similarly betrayed its hopes. The ministry it had worked to put into office in 1984 with expectations of a more intelligent and more compassionate – more social democratic – injection of the state into economic and social life had instead injected market forces into the economy and postponed social policy review largely until its second term, with strong hints that even there the state might not be as pervasive a participant as Labour tradition expected. As 1988 dawned that anger and frustration intensified to the point where the Government's ability to hold to its economic programme was doubted by many.

At the heart of the discontent was "Rogernomics" – the popular word for the economic policy approach of Roger Douglas. Rogernomics deregulated where Muldoon had regulated, turned over to market forces those whom Muldoon had subsidised, cut taxes where Muldoon had raised them, subjected employers and unions to the painful wage discipline of controls on the money supply, exposed Muldoon's state departments to the market by turning trading operations into corporations and requiring some other departments to earn part of their keep by selling their services. Where the National Party revolt had as its byword the phrase "more-market", meaning greater reliance on market forces, Rogernomics was in practice "a lot more market". Some people became very rich in the free-for-all that developed in the property and share markets, while, from 1986, increasing numbers of people were put out of work or otherwise made beneficiaries of the state. Labour idealists' sense of equity was deeply offended. At any time in 1988 it is probable that a free vote in the severely depleted grassroots of the Labour Party would have overthrown the policy stance.

Within this ironic parallel lies another. At any time from early 1979 up to July 1984, when Douglas came to office, there would have been a majority in Parliament for less regulation and more reliance on market forces than Muldoon allowed – and that majority would have been constituted of substantial numbers in both the Labour and National Parties. At any time from about six months into Douglas's tenure of office onward, there would probably have been a majority – drawn from both parties – for more regulation and less reliance on market forces than Douglas had instituted.

Thus each politician, Muldoon and Douglas, in his own way set a pendulum out towards the end of a swing. They have each been a focus for the tensions that have racked the New Zealand political system, and the parties within that system, as politics realigns to new social structures and aspirations. In an unstable state of affairs, both Muldoon and Douglas added to the instability. Somewhere out of that racking will come a new, durable alignment. The question is: to what extent will "Rogernomics" be a part of the new status quo?

The origins of Rogernomics are complex. Rogernomics is not, as some think, the work of one man or a small coterie. In its detail it is that. But its genesis and the "window of opportunity" (to use a phrase of which Douglas is fond) that permitted its development and implementation is multifaceted.

There was, first, a tidal influence. The intellectual initiatives in western-type societies passed from the "left" to the "right". During the uneasy 1970s, the belief in the power of collective action, particularly expressed through the state, to ennoble and enrich the community and individuals within it, lost its ascendancy in thinking on social, political and economic organisation. The "great societies" confidently planned for and expected in the 1960s receded over the horizon. Instead, there was increasing social fragmentation and moral uncertainty, increasing violence at the street level and at the level of grand international drama (for example, in aircraft hijackings and local wars) and economic stagnation and disruption. Collective solutions seemed to a growing number of people to be powerless to correct the failures and even to have contributed to them. Consequently, systems of intellectual thought which take the individual as their base were re-examined and redeveloped; overshadowed since the 1930s, they had by the 1970s a newness and a freshness that socialist, social democratic and Keynesian solutions had lost in extensive application.

That intellectual strand appealed in politics first to conservative political parties - or, rather, the radicals of the "right" within them: thus, for example, the "Thatcherites" in Britain or the "supply-siders" in Republican circles in the United States; and thus, the "more-market" tide within the National Party and, when Muldoon dammed that, the emergence of the New Zealand Party to give voice to "free-market" political demands.

But the tide also tugged at the socialist and social democratic parties. They began to re-examine the efficacy of their prescriptions. The French Socialists, for example, while in office in the early 1980s, switched tack away from nationalisation and Keynesian pump-priming; the Australian Labour Party in office from 1983 began to liberalise and open up the economy; the "negotiated economy" of social democratic Austria which had delivered apparently indestructible prosperity since 1945 began to unravel and market disciplines began to be reapplied - by a Socialist-led Government; the Socialist Government in Spain in 1988 started to sell off state trading companies. Even communist governments have experimented with market mechanisms and in some cases, notably China, to privatise land and state enterprises. In New Zealand a new breed of Labour MPs in their thirties began in the early 1980s to question established policy assumptions.

Douglas was not the only or even the leading questioner. He was just the most radical. Perhaps the pivotal shift in the Labour Party was when in late 1979 the then leader, Sir Wallace Rowling, whom Douglas saw as a blockage to the development of new ideas, appointed David Caygill chairman of the caucus economic committee with a brief to re-examine policy. That questioning did not lead to a radical repositioning, for Caygill is a liberal by instinct, not a radical; but it did loosen the soil for more radical shoots to push through.

When those shoots did push through, they met a warm and inviting climate. Deep change had already been under way for some time - in the economy, in the psychology of decision-makers in the economy and in national aspirations.

In New Zealand the economic stagnation of the 1970s was felt more keenly than in many other countries. For three decades growth had been about half that of other western countries as the earning power of unprocessed or semi-processed pastoral products - chiefly lamb and beef, wool and dairy products - had fallen behind that of industrial products and even further behind the emerging knowledge-based and service industries. By the mid-1980s the terms of trade were nearly 30 percent below that of the early 1960s and 40 percent below the peak in 1973 before the first oil shock.

In retrospect, the terms of trade turned down from the mid-1960s after a four-year trough around the turn of the decade. But up till about 1980, governments treated it as a temporary aberration and borrowed abroad to maintain consumption. In 1980/81 Muldoon, recognising the drop was persistent, borrowed additionally to fund a series of energy-based heavy industrial projects for export or import substitution. The debt burden spiralled: official overseas debt rose from 5 percent of gross domestic product in March 1974 to 24 percent in March 1984.

So did inflation – averaging 14 percent from 1975 to 1982. And so did unemployment, reaching a pre-Douglas peak of 131,700 including those on state-subsidised work (more than 9 percent of the workforce) in January 1984. Interest rates climbed as Muldoon tried in non-election years to restrain money supply and credit. In mid-1982 Muldoon tried fiat instead of policy – he froze prices, wages and rents. Controls on interest rates followed in 1983. By then supplementary minimum payments – output subsidies – to farmers had peaked at $352 million in 1982/83 and export tax incentives to manufacturers were running about $700 million a year.

By 1983, too, there was a widening sense that New Zealand was heading up a cul-de-sac (to quote the title of a contemporary book on New Zealand society by geographer Harvey Franklin[1]): a dead end in economic direction and in economic policy.

To some extent this view was not entirely justified. There had been some liberalisation by the Muldoon administration – notably in meat industry delicensing, shop trading hours and union membership – and some gestures towards freer trade with the Closer Economic Relationship free trade agreement with Australia, import licence tendering, removal of protection for intermediate goods and agreement with manufacturers on general reduction of protection. Slowly, through a series of industry plans, the Government was nudging manufacturing activity away from blanket substitution of imports of consumer goods towards activities that could be internationally competitive. Overall the moves, even if they were limited, represented a major change in direction.

The economy had also been changing structurally. Pastoral primary products were markedly less predominant in exports, having fallen from 92 percent in 1965/66 to 62 percent in 1980/81. Manufactured exports had risen from 5 percent to 19 percent. Within agriculture there was considerable diversification. Horticulture and fishing flourished. The liberalising moves of the early Muldoon Government years had encouraged that deepening and broadening.

But rigidities in the Government's economic management from 1982 onwards were hindering the development. As Professor John Gould of Victoria University has written, ". . . by the 1980s the industrial and service base of the economy had been sufficiently broadened, the range of skills and entreprenurial talent sufficiently widened and deepened, to make it desirable to move to a more free market environment". He added:

> It is impossible for all major sectors simultaneously to subsidise the rest, for then what each sector gains through the subsidies it receives it loses again in the extra taxes it pays or costs it bears in order to subsidise the others . . . Had nothing else done so, the rise in subsidies to farming in the 1970s and 1980s would therefore have provided a compelling argument for reviewing the whole structure of industry assistance.[2]

And in policy terms, the period of government by diktat from 1982 swamped the liberalisations.

A growing number of New Zealanders were therefore, for one reason or another, agreeing with the title of another book, *There's Got to be a Better Way*, written by Douglas in 1980.[3] These different New Zealanders proposed many different "better ways". But the predominant momentum at the intellectual and political levels was for liberalisation and deregulation.

This was reinforced by another momentum: a new spurt in the growth towards maturity of New Zealand as a nation. Part-pushed, part-pulled and part-self-generated, New Zealand was taking another step away from its monocultural colonial mentality towards independence.

The push came from its European progenitor: Britain joined the European Community in 1972. The special trading relationship with New Zealand – primary produce for finished manufactures – was supplanted by a new relationship with continental Europe. The sentimental attachment lingered, but was markedly diminished among a younger generation. Few New Zealanders under forty in 1984 would have said, as Muldoon did in 1973, "No EEC and no British or New Zealand Government will break the ties that bind us to the lands from which we came."[4] Britain was not "Home" to New Zealanders born after the Second World War.

The pull came from the geographical neighbourhood. In a variety of ways the Pacific became increasingly the focus of New Zealand concerns and hopes. Its defence concerns were Pacific from the end of the Second World War. Its trade focus shifted to North America, the rising economies of east Asia and Australia. The Pacific provided an increasing proportion of immigrants and, consequently, of the population. And, as the Maori recovered their cultural strength and confidence, that Pacific dimension forced its way into the Eurocentric national consciousness.

Within New Zealand there was also a new confident – or brash – expression. It was evident first in the arts and crafts: pottery from the early 1970s, glassware from the early 1980s, an outpouring of writing, plays and films from the late 1970s onwards and, in the 1980s, dance; perhaps the rapid development of good winemaking in the 1980s is another example, as winemakers no longer felt themselves constricted by overseas styles and, particularly with the sauvignon blanc grape, began to develop distinctively New Zealand wine.

This new self-confidence was also by the late 1970s and early 1980s beginning to emerge in other fields: in politics; in business; and in the bureaucracy, particularly in the Treasury, which began to push harder for a freer economy, and in the Ministry of Foreign Affairs, which urged new perspectives in external relations and took a leading part in the development of a closer, more open relationship with Australia.

This paralleled the emergence of a new generation into its thirties and forties. It was a generation brought up in the most affluent period of history, even in relatively slow-growing New Zealand; a period also of a stable moral and social order. The economic security made people of that generation less concerned with their parents' obsession with security and more willing to take risks. The stability frustrated them. They wanted new ways of doing things and had the self-confidence to try them out.

In business this generation contributed a new style of entrepreneur, capable of thinking internationally and impatient with the style of its predecessor generation which had operated within a symbiotic relationship with the state. The new entrepreneurs wanted to develop businesses that were free to do commerce with foreigners and able to compete with them. That naturally led them to the less-regulated, less-establishmentarian businesses, such as merchant banking or consultancies or property development. Many of them made their mark, and a lot of money, in financial, share or property trading in the speculative boom which developed in the mid-1980s deregulation (and some have made their mark since in the list of spectacular company crashes). More important, by the mid-1980s others were apparent in the middle and upper ranks of the more "respectable" businesses, injecting a new energy into staid and unimaginative managements. The usual picture of these people is of the got-rich-quick hucksters; but that was only one emanation of a much broader shift in attitudes in business.

Consequently, when first the new breed in the National Party and then the deregulators in the Labour Party began to dismantle regulations and protection, they found a ready reception in a widening and increasingly influential segment of business. Where in the early 1970s the political door to deregulation and deprotection had been locked, bolted and barred by business lobbying (to the electoral cost of the timidly deregulatory National Government in 1972), by the early 1980s it was, if not yet ajar, at least open to a turn of the handle and a good shove. Muldoon would not turn, let alone shove; Douglas was of a mind to kick the door down. So were most of the influential bureaucrats, increasing numbers of whom were of the new generation.

The creative confidence and independence that was evident in arts, crafts and business was also, differently expressed, one of the driving forces in the anti-nuclear movement. The ANZUS defence treaty with the United States and Australia represented a dependency (upon the United States) which did not sit easily with that emergent independence of spirit. Consequently, an idealistic opposition to nuclear power and arms that might have been expressed in attempts to generate multilateral action to eliminate nuclear weapons instead found expression in a unilateral rejection of nuclear weapons in home waters.

The New Zealand perspective on the break that the resultant Government ban on visits by warships capable of carrying nuclear weapons caused is that the United States' inflexibility wrecked the ANZUS treaty. There is some truth in that: a hawkish (uncle) Administration was unreasoningly inflexible in severing defence ties; (indulgent parent) Britain had never been so abrupt. The Americans acted as if New Zealand was a wayward brat that needed a good whack round the ears.

But the New Zealanders' perspective also owes something to the fragility and newness of their sense of independence. If New Zealand had been a wayward brat, it would have come to heel smartly. In 1939 when the British bankers threatened to cut off the colony's credit because of its socialistic experiments, the wayward brat Labour Government of the day became a model of fiscal probity (surplus budgets) thereafter. In 1985, however, New Zealand was no longer a brat, but a flouncing adolescent, full of its new wisdoms and of frustration at the slow-moving out-of-dateness of the older world. Far from cowering before the cane, it turned on its heel. This was no phenomenon of the wild left: many New Zealanders who had been in favour of retaining ANZUS at the cost of ship visits nevertheless took the Government's side in its standoff with the United States and took some pride in that.

New Zealand is young. The Europeans have been living in New Zealand only a century-and-a-half, most for three generations or less. They have still not developed a distinctively New Zealand identity in the way the Iberian-settled South American countries or the European-settled North American countries have. New Zealand's internationally recognised famous have almost without exception won their fame with doings in other countries. The Maori have been in Aotearoa a millenium, but they have also been displaced: frog-marched from small tribal communities into contemporary European urban culture. What it is to be a New Zealander in this dual-race, displaced society is not clearly defined.

Youth is flexible, excitable, energetic. It can take to new ideas easily and enthusiastically. It can plunge completely into them without reserve. It has the energy to take them as far as they can be taken.

Frustrated with a sclerotic economic order and brash with the self-confidence of an upbringing in the affluent 1950s and 1960s, young New Zealand was easily swept into, and swept along, Rogernomics.

The economic cul-de-sac into which New Zealand had headed dictated that anything was better than the status quo. There was in any case already under way a substantial self-induced restructuring of the economy, which the policies of the latter years of the Muldoon Government were hindering. The tide of intellectual initiative was towards deregulation and liberalisation, more reliance on individualistic solutions and less on collective ones. That was consonant with an emerging independence of spirit in a new generation made self-confident in an affluent upbringing. And the brash adolescent of a young country eager for independent adulthood made it receptive to a radical shift in government policy.

That shift came from an unexpected quarter. The liberalising drive within the National Party stalled under the controls Muldoon imposed from 1982 during what Gould has called "the extraordinary period of 'personal' government".[5] It diverted into the New Zealand Party, led by a property magnate, Bob Jones, once a personal friend of Muldoon and substantial financial backer of the National Party. Simultaneously, a leadership change within the Labour Party had enabled it to gather in a dissident vote which had in 1978 and 1981 gone to the Social Credit Political League.

So the Labour Party was elected, with just over two-fifths of the vote, in 1984. Within the Labour Party, as its Finance Minister-designate, was Douglas, nursing his ideas for a "better way". Waiting for Douglas were a Treasury and Reserve Bank full of officers with ideas close to Douglas's thinking and inviting him farther down that route. Once in office, the two fed each other, led each other on.

Douglas was of Labour stock. His father had been a union official and then a Labour MP. His maternal grandfather had been a minister in the second Labour Government from 1957–60. In his twenties he quickly rose through the ranks of the Labour Party in Auckland to the regional presidency. But Douglas was no manual worker: his trade was accountancy and as company secretary to a manufacturing company, UEB Industries, he was exposed to other influences. As a young MP from 1969 and then as a minister from 1972 (at the age of thirty-four), he questioned traditional Labour approaches and began to develop his own, including a national contributory superannuation scheme which was enacted in 1974. He also showed, as Minister of Broadcasting, qualities that were to mark his tenure of the finance ministry: the self-confidence and individuality to produce off his own bat a radical plan for restructuring the state broadcasting services which incorporated a belief in the value of competition by requiring the two television channels to compete, even though both were state-owned. And, frustrated in opposition after 1975, he showed entrepreneurial skill in developing his grandfather's backroom herbal remedies business into a substantial health products manufacturing unit.

Douglas as Finance Minister could, therefore, be expected to operate as a determined individual rather than as a careful team person; to develop radical new approaches and drive them through; and to ditch old Labour ideas where he felt they did not work. By chance, the conditions in which he obtained office gave him remarkably free rein.

Douglas's "better way" in his book was recognisably "Labour" in some respects, most notably a proposal for a Government Savings Corporation which would direct capital into industries pinpointed to have a good future: "No successful business does everything. It chooses priorities. So should a nation."[6]

But it was a radical break with most Labour thinking: a flexible exchange rate; market mechanisms, not direct controls, to keep prices and interest rates down; the removal of import licensing; a shift to indirect tax; the killing off of unnecessary government departments; the killing off of "sick industries" instead of subsidising them; flexible wages and work practices and a workforce able to move from decaying industries to rising ones. It was not a paean of praise to supply-side economics; but it did owe a lot to supply-siders' thinking as an alternative to traditional Labour methods. This is not suprising: among Douglas's friends at the time were people like Don Brash (now Governor of the Reserve Bank) and Alan Gibbs (now chairman of Ceramco), strong advocates of the market economy.[7]

For that sort of thinking Douglas had been exiled to the back benches by Rowling in 1980 and his policy approach was the focus of serious disagreement, led by the president, Jim Anderton, within the Labour Party. But where it counted, in the upper reaches of the parliamentary party, Douglas developed a growing influence as shadow finance minister during the Lange leadership, which began in February 1983. Lange, having declared himself ignorant of economics, learnt his economics from Douglas and was carried along by the logic of Douglas's arguments and Douglas's declared aim that his methods were intended practically to improve the lot of the least-well-off. The deputy leader, Geoffrey Palmer, who had been a professor of law, took advice from former academic colleagues which led him to market economics. The Number Three, Mike Moore, whom Palmer narrowly defeated for deputy, adjusted his "socialist" preferences to accommodate parts of Douglas's approach. Others who had formed, with Douglas, the faction which put Lange into the leadership; had tacitly or actively accepted his main thrust. The most enthusiastic was Richard Prebble, who became an Associate Minister of Finance to Douglas in 1984.

More important was Caygill, the other Associate Minister of

Finance and Minister of Trade and Industry, for which he had held the shadow portfolio in opposition. Caygill was a liberal convert from the National Party, in which he had been an office-holder in the Young Nationals. He had been going through his own development, first in the chair of the caucus economics committee and then as associate to Douglas. That development did not take him as far down the market route as Douglas, but it did take him in that direction. For example, as early as May 1980 he said that the Labour Party shared the National Government's "enthusiasm for restructuring so that our economy is more market-oriented".[8] And in late 1982 he could say: "I want to see central government off the backs of private enterprise".[9]

It was obvious, from reading the speeches of the senior shadow ministers in the Labour Party Opposition in 1983 and 1984, that in government they would head a liberalising ministry on economic issues, at least in microeconomic policy. The accent on competitiveness, less regulation and lower protection made that clear.

Scope for a market approach was also preserved in the economic policy statement during the 1984 election campaign. For the Labour traditionalist the statement proposed a highly interventionist policy in incomes and investment and pursued full employment, fairness and social justice and "greater control by New Zealanders over their own economy".[10] But it also aimed for economic growth and permanent reduction of the external and internal deficits, inflation and interest rates, using principally a firm monetary policy and competition, and even explicitly stated that "existing financial regulations will be reviewed with a view of eliminating as many as possible".[11] The tax reform section was so loosely worded that almost anything could have been done in its name. In short, the market-oriented leadership preserved its room for manoeuvre against a series of largely unsuccessful attempts in the Party's policy council by the party president, Anderton, the Public Service Association economist, Peter Harris, and Dame Ann Hercus (who was to be Minister of Social Welfare, Police and Women's Affairs) to spell out a more traditional Labour approach.

But nothing prepared the country or the Labour Party for the extent of Douglas's onslaught: the removal of financial controls and the floating of the dollar, the removal of subsidies, the tax switch, partial labour market liberalisation, the commercialisation of state trading enterprises (and later, to reduce debt, their privatisation).

Palmer later insisted to aghast Labour Party members that all Douglas was doing was restoring orthodoxy to economic management and that it looked dramatic only because Muldoon had been so interventionist as to have become highly unorthodox. But the conservatism implied in Palmer's comment was a misleading characterisation of Rogernomics.

Rogernomics, as it was expressed in government policy during Douglas's term, was not one element but two: content and process. Though in content it was liberal, in process it was radical.

In content, it was market economics, to maximise efficiency and competitiveness ("effective and efficient economic management is the major goal of Labour's economic policy," the 1984 election policy statement said[17]). The state's role was to promote as price-transparent and neutral an economic environment as practicable, to eliminate what Douglas called "privilege" by putting all sectors, industries, enterprises, professional bodies, segments of the workforce and individuals on as near to an even footing as practicable. For the private sector this involved the reduction of protection, deregulation of industries, occupational bodies and markets, the removal of subsidies and sectoral tax concessions and charging for the provision of state services to industry. For the state sector it meant commercialisation of trading enterprises and the improvement of efficiency in the non-trading departments by decentralisation. In macroeconomic policy it involved no direct interference in foreign exchange, prices and wages, a steady monetary policy and reduction of the fiscal deficit.

Douglas did not promote this policy approach out of an ideological belief in the market or individual freedom, but because he saw it was a practical means to generate greater wealth and welfare, given what he saw as the rigidities of centrally planned and controlled economic management and its consequent failure to generate growth. Rogernomics was liberal in content rather libertarian, practical rather than doctrinal. In the later stages, as each stage of liberalisation or removal of privilege seemed inexorably to require another, it did appear almost doctrinal – for example, in its charging for government services even if that reduced scientific research in areas directly relevant to the New Zealand economy or in deregulation of the cartel-prone petroleum industry or in its advocacy of single-rate taxation or its stalled push for much greater labour market deregulation. But in the crunch, doctrine for Douglas was subsidiary to what he saw as the practical effect of specific policies. This was one reason for Douglas's impatience with the "left": that the traditional Labour solutions urged with what he saw as doctrinal blindness worked perversely against the "left's" declared aims for the less-well-off and the least-well-off. (The "left" in turn argued that the methods Douglas chose determined the social outcome in ways that both in the short term are, and over the longer term will be, harmful to the less- and least-well-off.)

There had been widespread praise among economists and most business leaders for the microeconomic liberalisations, as far as they went, even from some who otherwise oppose Rogernomics. For example, Fletcher Challenge chief executive Hugh Fletcher, a self-described Keynesian opposed to the macroeconomic liberalisations, told the writer in an interview in February 1989 that "the great feature of Rogernomics is the productivity improvement. . . It is remarkable to have sizable productivity improvements when volumes have been going down."[13] Systematic evidence of such improvements is sketchy, but anecdotal evidence suggests they have been widespread and substantial. Management has also improved, particularly in stock management. Andrew Hibbard, chief economist of the ANZ Bank, told the writer in an interview in February 1989: "Almost every business in New Zealand tells you it now runs satisfactory inventory at a stock level that is probably half to 60% of what it thought it could do seven to eight years ago."[14] There have been substantial productivity improvements in most of the commercialised state trading enterprises: for example, the Coal Corporation sacked half its workforce on 1 April 1987 but maintained output. Efficiencies are being forced into the non-trading state sector. The restructuring that began slowly in the private sector under the Muldoon ministry has been dramatically kicked along and extended into the state sector.

Economists are less enthusiastic about, and in many cases (even some of those otherwise supportive of Rogernomics) strongly critical of, the handling of macroeconomic policies. Rogernomics had been "two things going on in tension against each other," Alan Bollard, director of the New Zealand Institute of Economic Research, told the writer in an interview in February 1989. "We have had micro liberalisation, generally removing entry barriers, increasing competition, giving out a general picture of a set of incentives inviting businesspeople to invest and to reap the rewards of that investment. At the same time the macro environment has put out completely opposite signals – broadly, high interest rates and a high exchange rate. And those are saying, first, that capital is costly, so don't invest, and, second, that New Zealand is not competitive, so don't invest here."[15]

From the right and the centre critics have said Douglas's policies were unbalanced, with too heavy a reliance on monetary policy and microeconomic liberalisation instead of a broader mix of measures, and were wrongly sequenced or unevenly applied, favouring some sectors (manufacturers against farmers, the state sector against the private sector, labour against capital) over others. His failure to balance the budget before floating the dollar, coupled with the blunt use of monetary control to rein back inflation, they have said, led inevitably to high interest rates and on their back a high dollar that seriously damaged the tradeables sector, kept the country for the first four years chronically in deficit on the balance of payments and pushed up overseas debt (though also privatising it). Critics from the right – or from business squeezed between high interest and exchange rates on the one hand and wage rigidities on the other – have added that Douglas's failure to do more than partially deregulate the labour market worked against other changes. The result, some critics point out, is that most of the productivity improvements have been the result of cost-cutting rather than the more desirable productivity-enhancing investment.

From the left critics have complained that the liberalisation has made a favoured few rich while unnecessarily raising unemployment to levels unacceptable in New Zealand and forcing deterioriation in working conditions and wages of those in work; that is, favoured capital against labour. They have argued that the blunt monetary weapon chosen to defeat inflation in fact contributed to it through higher interest rates and may actually have delayed a fall they say was likely in any case. From the left and the centre some have argued that elevation of inflation to the highest priority of macroeconomic policy pushed the economy further into recession than necessary and damaged potential for growth.

Douglas, with support from Bollard, counters critics of the "sequencing" of his changes by saying that if he had had to wait for the right conditions to liberalise markets in the order they want, he would have moved so slowly the beneficial effects would have been lost. He scrambled quickly through the "window of opportunity" that was open when he took office – the liberalisation of the financial markets – and used that to prise open other windows.

That defence illustrates the second element of Rogernomics: its process. Douglas moved fast and suddenly, presenting his critics and doubters repeatedly with *faits accomplis* they could only complain about, not prevent or delay. The operational rationale was that people respond to a strong lead and that changes made quickly were more likely to produce quick results and so public acceptance.

Since there were critics and doubters even within the Cabinet, the process was all the more necessary if Douglas was to get his changes to stick. He and his associate ministers first carried along the eight-minister Cabinet policy committee, the Cabinet's powerful central committee. With that committee onside, a sort of cascade of acquiescence then flowed through the party: the Cabinet fell into line with the policy committee, the parliamentary party with the Cabinet, the party executive and council with the parliamentary party and so on.

Douglas was much aided by the existence of a sympathetic – that is, persuadable on practical grounds – segment of the party membership. That segment provided around one-third of the delegates to the 1985 Labour Party conferences which approved the introduction of the goods and services tax. He was also aided by a determination in the party membership that the Government should have two terms, which stifled criticism. And occasionally, when it looked as if he might be blocked, he was often able to get most of what he wanted by forcefully pursuing the totality. In 1986, for example, he did not achieve as much liberalisation of the labour market as he sought; but he ended up with a compromise which arguably he would not have got if that had been his starting point. The same goes for the 28 percent core personal income tax rate and 33 percent top rate announced on 10 February 1988, after his proposal the previous 17 December for a flat tax was scrapped: those compromise rates are astonishingly low for a Labour Government.

This process was also greatly aided by the small size and simple political machinery of New Zealand. In a country of only 3.3 million, the ruling élite, in politics, the bureaucracy, business, the unions and the lobby groups, is small and on first-name terms and can easily act in concert. Driving through change, therefore, meets fewer obstacles than in larger countries with more diffuse élites. The legislature consists of only one house, in which almost invariably the members of Parliament from the ruling party have a majority. In turn the members of Parliament of the ruling party are bound to support the position taken by their caucus, which seldom overturns decisions of the Cabinet.[14] The checks and balances of a more complex system might have stopped Douglas in his tracks. The "elected dictatorship" that characterises New Zealand's political system gave him direct and little-fettered access to the levers of power.

An example of that mechanism in operation was the State Sector Act. The Act devolves much greater responsibility and accountability to departmental chiefs, who are now appointed by the Cabinet on fixed five-year contracts. Wage and salary fixing, formerly a centralised translation of averaged private sector rates, is now on a similar basis to that in the private sector, with departments responsible for conducting their own negotiations. Within global budgets set by the Cabinet the department chiefs have a great deal of flexibility and thus savings are rewarded with, for example, freedom of manoeuvre in wage and salary fixing and in programme initiatives. That is a sharp contrast with the previous system which encouraged spending up to budget as a springboard for more funds in the Budget round.

The bill was drafted in two days in mid-December 1987 after the settlement of the wage round with the Public Service Association. By 31 March it had been rammed through Parliament despite extensive protests from public servants and from constitutionalists protesting that the first fundamental reshaping of the state administrative system since 1912 should have been given more mature consideration. In the Budget on 28 July 1988 Douglas used the Act to put on chief executives the responsibility for meeting budget ceilings containing a minus 2 percent allowance for inflation, thus forcing savings that otherwise could not have been achieved in the time.

Two factors made that machinery even more available to Douglas. The power of one élite that had endured for forty years was in decay, creating conditions for the rise of a replacement élite which thereby had more room to introduce change. Second, the élite on the way out held up change, a resistance personified and taken to the extreme by Muldoon. That dammed up change until some change was irresistible; it created conditions, in business, the bureaucracy and politics, that welcomed any change and so opened the window to radical change.

The result – liberal practical market economics applied by radical process to overturn a decaying order – was an intoxicating mixture, sending people dizzy with delight or drunk with rage. It went far further than anyone, even Douglas (in 1984), expected. It made New Zealand, and Douglas, the focus of would-be liberalisers' attention around the world. Foreign journalists first used to come to New Zealand to examine the "wild left" anti-nuclear policy. More recently they have come to examine the "right-wing" economic programme.

They have puzzled that a Labour Government has made those changes. So have large numbers of New Zealanders. From 1983 to 1988, New Zealand politics appeared topsy-turvy, the conservative party appearing "socialist" by comparison with a "free-market" socialist party. In the 1987 election this appearance was transmitted to the ballot box: some urban blue riband "National" seats either toppled or nearly toppled to Labour, while working class seats swung against Labour.

That appearance is deceptive. The topsy-turvy image was essentially the projection of two determined personalities: Muldoon and Douglas stamped policies on their parties that their parties would not have chosen, though for a time went along with. In the end, the National Party broke with Muldoon and has been working its way back towards its more traditional place in the political spectrum.

The Labour Party broke with Douglas shortly after the 1987 election. A year later its Government broke with him, too.

From early in 1988 it was clear Douglas's tide of influence had reached its peak.[17] Whatever the economic logic of further reform (Keynesian Hugh Fletcher, for example, told the writer in February 1989 that although he thought the Government should not have started down Douglas's route, "I now think the worst thing they [the Government] can do is slow down"[18]), Douglas had gone beyond the reach of his political supply lines. The process of radical reform had caused widespread pain, disruption and fear, much of it among the most vulnerable who make up Labour's principal constituency.[19] The Government's popularity plummeted to the lowest figure for a government in New Zealand since public opinion polls began. In addition, large numbers of people normally allies of the Labour Party were disaffected by a range of Douglas initiatives, especially those in the state sector.

Though Douglas continued to drive policy and to initiate changes, it became progressively more difficult for him. In February 1988 backbench members of Parliament broke ranks over the proposed sale of the state-owned Petroleum Corporation to British Gas and there was open revolt in the Labour Party regional conferences from March onwards. At the Labour Party conference in September, though the Government won the symbolically centrepiece vote on asset sales, there was an almost ritual condemnation of wide swathes of Rogernomics. Lange was increasingly sympathetic to elements of the party position. On 14 December a year of strain between Douglas and Lange over both budgetary matters and the degree to which market economics should be pushed into areas Lange considered social policy resulted in Douglas stating to Lange that he could not continue as Finance Minister with Lange as Prime Minister. Lange promptly sacked him.

Did Rogernomics depart with Douglas?

His successor, David Caygill, says it did not. He pledged himself on his appointment to implement "Rogernomics, stage II". That, however, is open to many interpretations.

One clue to Caygill's interpretation lies in his answers to questions put to him by the writer in February 1989 as to how much he was behind and with Douglas on the economic changes. He said he could not think "of any major issue that we [himself and Douglas] disagreed about".[20] But, questioned further, Caygill acknowledged some differences over degree and pace and refused to discuss Douglas initiatives that did not pass the Cabinet. "You are asking me to express a personal attitude about something that ultimately wasn't the subject of a collective endorsement. And I am loath to do that, because that is different from saying how I felt about something that in the end we all lined up behind."[21] In other words, Caygill seeks consensus where often Douglas operated by pre-emptive strike which limited scope for organised and considered opposition within the Cabinet.[22] That style will limit the likelihood of radical new economic policy initiatives under Caygill.

A second clue lies in Caygill's rejection of the recommendation by the Hospital and Related Services Taskforce – the so-called "Gibbs Report"[23] – of separation of funding and provision of hospital services. Caygill's approach was cautious and consensus-seeking. In other words, though as Associate Minister of Finance from 1984–87 Caygill was party to many radical economic policy changes and personally saw through deep cuts in protection, he is not a radical in the Douglas mould. Douglas claimed that there existed consensus for the taking of strong measures, but only a strong lead would deliver consensus on the individual measures taken; similarly, Lange said in 1986 that "the only way you achieve [consensus] is by success".[24] Caygill, too, in his interview with the writer, claimed a pre-existing consensus for a "more open and a more competitive economy",[25] but his protection reforms were less far-reaching and slower than Douglas wanted and were introduced only after protracted, consensus-seeking discussions with manufacturers.

Another indication that radical new moves are unlikely comes from the Cabinet's submission at the annual Labour Party conference in September 1988 to a formal consultative process with the Labour Party New Zealand council through a range of policy committees. Within a few days of his appointment in December 1988 Caygill defied the party by proceeding with asset sales and in February 1989 there were decisions to charge tertiary students one-fifth of their tuition and to cut $200 million off benefits which enraged the party. But over time the consultative process is likely to limit the Government's freedom to develop radical new policy.

Thus Rogernomics stage II does not mean Rogernomics as Douglas would have liked in an ideal world: a low single tax coupled with benefit rationalisation designed to leave wages clearly ahead of benefits; much greater labour market reform; much more far-reaching liberalising and cost-cutting changes in education, health and other services; and active reform of the local government and transport infrastructure — though movement on many of those fronts has continued since his departure. Nor does it even mean Rogernomics as Douglas would have pushed for in a Cabinet in which some compromise had been necessary even in Rogernomics stage I. After an intra-Cabinet battle in June-July 1988 over the low level of personal and company income tax rates, which Douglas won, it became obvious that he would not be able to hold the line on those rates in the 1989-90 Budget round, let alone push his flat tax proposal, even if he had stayed in the Cabinet. Caygill will push for less than Douglas would have.

Rogernomics' troubles in 1988 flowed from a flaw within it: the attempt to graft market economics, with its inevitable intellectual link to individualism, on to a political ideology that at base is collectivist. In practical political terms, Rogernomics has torn apart the party of which Douglas is part, in upbringing and instinct.[26] In policy terms, the flaw prescribes automatic limits to how far market economics can be taken. That in turn prescribes reform rather than radicalism and is likely to lead to a new conservatism. Douglas was temperamentally unsuited to both. Caygill is closer to that mould.

So, too, essentially is the National Party Opposition. Ruth Richardson, its shadow finance minister at the time of writing (March 1989), would, if left to herself, do much of Douglas's unfinished business and do with an ideological belief that owes much to Hayekian liberalism. But her ascendancy is not confidently predictable: the conservative strand in the National Party, to which the leader, Jim Bolger, belongs, is still strong and may well win the current policy debate.[27] Though a measure of further labour market liberalisation could be expected from a National Government (Bolger, after all, carried that in 1983) and there might be some more contestability introduced into the provision of education and social services, extensive new radical reform would be unlikely.

But Rogernomics is unlikely to ebb much either. The only circumstance in which the changes already installed would be likely to be rolled back would be a currency collapse, a collapse in the terms of trade, a deep international trade recession or some other economic catastrophe – and in these circumstances an about-turn would be as likely in a Bolger-led National Government as in a Lange-led Labour one.[28] Failing that, attempts to reimpose collectivist ideological economic management will be resisted within the present Government until a pro-market National Party is elected in its place, whether in 1990 or the following election. Although some in the Party and the supporting unions want a complete change in economic policy, only Anderton in the parliamentary Labour Party publicly urged it — and he left the party on 18 April 1989. Lange and Caygill have both reaffirmed that there will be no undoing of what has been done. Likewise, even the conservatives in a future National Government would have little inclination for much re-regulation and re-protection, though there might be some re-subsidisation. In any case, the internationalisation of the economy during the Douglas years, both in the financial markets and in the development of New Zealand-based multinationals, would make a reversion to economic interventionism extremely difficult, unless the international economy itself forced it.

In addition, that high tide which Rogernomics reached in 1988 was in new policy initiatives, rather than the effect of policy. The initiatives of 1984-88 will continue to force far-reaching changes through the economy and the state sector well into the future – even if there were no new measures at all. A great deal of manufacturing has yet to make the fundamental adjustment to the new economy and the process of closures, rationalisations and productivity improvements will continue for some years. A serious downward recapitalisation of overpriced farm, commercial property and hotel assets is now well under way and will have serious effects on the financial sector. Reforms are now being forced through in the ports, shipping and the freezing works, three areas of rigid labour practices and poor management in the past. Cost-cutting of social services, particularly hospitals, in 1989 appeared to be opening more scope for private sector provision and funding of those services — perhaps the beginnings of a major shift in the role of the state in social services. Given the political constraints under which Douglas would have had to operate even if he had stayed to drive policy initiatives, the actual outcome is not likely to be greatly different than it would have been had he remained.

That is not to say that there will not be changes to the economic management stance as radicalism gives way to reform and eventually the new conservatism. Lower (though not yet defeated) inflation has given more scope for flexibility in other areas of policy, such as unemployment. There may be room for the reintroduction of some subsidies, along the lines of the facilitating assistance (market research, for example) given exporters by the Market Development Board.

But Douglas has broken the mould. A new order is being bedded in. It is not an order written entirely in Douglas's image, still less according to the "new right" or libertarian ideologies; it is "more market", not free market; the state remains active as an integral part of a "mixed economy". But the new order is even more distant from the command economy concepts that underlay the order established by the first Labour Government in the 1940s. The state will be a less active part of the mix than in the past forty years and it will be differently active. Rogernomics has dramatically changed the economic landscape.

This book is published as the boundaries are set to Rogernomics and thoughts are turning to what follows.[29] But, as Lange said the day he left the Cabinet, Douglas's "place in history is very secure".[30] His political epitaph will state that he changed, radically, both the lines of economic management and the premises of the national debate – and even the way it is conducted. Few, if any, politicians have had a commensurate impact.

Notes

1. Franklin, Harvey. *Cul de Sac: The Question of New Zealand's Future.* Wellington, Unwin Paperbacks in association with Port Nicholson Press, 1985.
2. Gould, John. *The Muldoon Years.* Auckland, Hodder and Stoughton, 1985, p. 80.
3. Douglas, Roger. *There's Got to be a Better Way.* Wellington, Fourth Estate, 1980.
4. Muldoon, Robert. *The Rise and Fall of a Young Turk.* Wellington, A. H. and A. W. Reed, 1973, p. 5.
5. Gould, J., op. cit., p. 73.
6. Douglas, R. op. cit., p. 56.
7. A summary of the evolution of Douglas's economic thinking and the influences on him can be found in: James, Colin. *The Quiet Revolution.* Wellington, Allen and Unwin, 1986, pp. 136–140.
8. "Labour's broad economic strategy seems like National's but Caygill points out the differences". In: *National Business Review*, 19 May, 1980, pp. 10–11.
9. David Caygill, speech to Aggregates Association, 21 September, 1982. Typescript in writer's possession.
10. New Zealand Labour Party. *Economic Policy 1984.* Wellington, photocopied typescript document, p. 2.
11. New Zealand Labour Party, op. cit., p. 10.

12. New Zealand Labour Party, op. cit., p. 2.
13. Transcript of taped interview for the *Far Eastern Economic Review* in writer's possession.
14. Ibid.
15. Ibid.
16. The National Party does not make voting according to caucus decisions mandatory, but custom, backed by a strong "whipping" system, makes it very close to mandatory. The Labour Party constitution explicitly requires members of Parliament to adhere to caucus decisions. When in 1988 Jim Anderton as a Labour backbench member of Parliament refused to support a bill to enable the Government to sell the Bank of New Zealand (on the ground that the bill was against the party manifesto) the Cabinet drove a resolution through the caucus of Labour members of Parliament expelling him from the caucus. This was subsequently withdrawn after it became clear (and was subsequently so ruled by the party's New Zealand council, the guardian of the party constitution between conferences) that constitutionally the caucus did not have power to expel members of the Labour Party elected to Parliament who under the party constitution are members as of right of the caucus and cease to be so only if expelled from the party, a power reserved to the council, which refused to endorse the caucus action. But the sanction was enough to dissuade nine other Labour members of Parliament who opposed the sale of the Bank of New Zealand from also abstaining on the bill. Occasions when members of Parliament of either the Labour or National Party have refused to vote according to the parliamentary party position have been very rare.
17. The first draft of this chapter, written in April 1988, said: "So Rogernomics has reached its high tide. Douglas will have an important influence in social policy, principally in driving through efficiencies. But Rogernomics will reach no further."
18. Transcript of interview, op. cit.
19. "Those in the least assured position are still eroding in terms of the quantity and quality of their living . . . It's amazing we haven't been slugged for not doing more on that before now," Lange told the *National Business Review*, 11 July 1986, p. 17.
20. Transcript of interview, op. cit.
21. Ibid.
22. Douglas "had his own ways of pre-empting Cabinet decisions and avoiding Cabinet discussion of elements of the finance policies," Geoffrey Palmer said in a speech to the women's afternoon meeting of the Nelson Labour Party on 11 January 1989, typescript, p. 14.
23. Hospital and Related Services Taskforce. *Unshackling the Hospitals*. (The Gibbs Report) Wellington, 1988.
24. *National Business Review*, op. cit., p. 17.
25. Transcript of interview, op cit.
26. Anyone doubting Douglas is part of the Labour Party is referred to a speech he gave to the Canterbury Chamber of Commerce on March 30, 1988. Economic policy had two principal concerns, he said, efficiency and equity. "Certainly,

part of our job is to create an environment in which New Zealanders can increase the wealth of the nation. The other equally important bit of it is to even up the odds a bit for any sector, group or person who starts from a disadvantaged position. . . Sometimes you have to provide disadvantaged groups with extra assistance in order to get the playing fields level to start with." He added that the objectives of the Government were "a better quality of life, jobs, pay, health, housing, education, security, fair access for everyone to those benefits, a fair opportunity for people to achieve their own human potential. . . Good government should liberate people, not enslave them, either to the state or the private sector. People need a genuine guarantee of dignity, security, the ability to enjoy life even if things go wrong for them. Otherwise you end up with beggars in the street and the rich living behind barbed wire. But security alone is not enough. Nobody wants to live forever dependent on the government. Our job is to open out the future for people at every level. Those who start behind the line need more opportunity, not less, than people who start with an advantage.

27. At the time of writing (March 1989) Bolger was under some pressure. However, the most likely replacement, Winston Peters, was also of the conservative strand of the party.
28. And in a Peters-led National Government.
29. As this chapter went to print, there were moves to reinstate Douglas in the Cabinet amid considerable flux and uncertainty, Caygill had said publicly he would be prepared to stand aside. But a return to the Cabinet was not expected to return him to his former pre-eminence as a policy initiator.
30. Transcript of Prime Minister's Press Conference 2.15pm, 14 December 1988, Prime Minister's Office, p. 2.

Chapter 2

THE ENDS AND THE MEANS

Roger Douglas, MP

WHEN THE PRESENT LABOUR GOVERNMENT was first elected to office on 14 July 1984, in a snap election called by the then National Government, we were in many ways better prepared than our political opponents. We already had a set of objectives, and agreed policies to attain them. We had had plenty of time in opposition to analyse what had gone wrong with the economic and social structure of the country, and why. We had also had more than enough time to devise viable and necessary alternatives to the existing policies.

One of the basic flaws which underpinned many of the problems of the previous administration had been a growing confusion over the role of government. It was a confusion, certainly, which had developed from historical factors and past ways of acting, socially, economically and politically. However, what serves a nation best at one stage of its development will not always be the most appropriate answer some 50 years later.

Circumstances change. Institutions, especially public sector institutions, lose their ability to keep pace with those changes. We had seen that the methods of the 1950s and '60s no longer brought the responses needed in the '80s to create opportunities for the unemployed, to give security to families or to provide decent social services for all.

Thirty years of government that "picked winners", whether these were farmers or manufacturers who could be subsidised to achieve a successful business and lifestyle, or steel mills and oil refineries which the state decided the country needed, had given New Zealand a mountain of internal and external debts rather than the security that was intended.

Therefore, one of the major philosophical differences in the new Government of 1984 was a change in its understanding of the roles of government and its ministers. The proper role of government is to ensure that the people get the best possible value from the country's limited human, physical and financial resources and to provide the maximum benefit for the whole population, in this case 3.3 million New Zealanders, and not just for favoured sectors or industries. Value for money from our resources and equity – basic fairness for everyone in the community – are the two basic goals of economic policy.

A government's first duty, then, is to work out its objectives. Secondly, it must develop policies to achieve those objectives; policies which take into account all the relevant factors and circumstances of the time. And, finally, it should set priorities within those objectives. The objectives, whatever portfolio they might fall within, including finance, are ultimately *all* social. They are to do with people's living standards, with their security and with personal and financial opportunities.

While it is important for a government to recognise this role, it is of equal importance that it understand and come to terms with what it cannot do. There are limits to its ability to create the kind of society it would like for those it represents, just as there are limits to how quickly it can achieve its objectives and realise its goals.

Remembering and remaining true to both the role and the chosen objectives can be hard for everyone at times, cabinet ministers included. It is especially difficult for a reforming government. Long-standing systems and structures, traditional patterns or political and lobby group behaviour, inevitably result in the political equivalent of the Pavlovian response. For thirty years, economic management in New Zealand was dominated by the demands of sectional interest groups which became used to having their demands met as each strove to win improvements for its own clique, even if those improvements were at the expense of the rest of the community. A succession of governments found it easier to take the politically soft option by attempting to offend as few of their constituents as possible, loading the inevitable consequences of debt and inflation onto future generations.

The constitutional and economic crises which followed the 1984 election were serious enough to shake everyone loose from these habitual lines of communication, for a time. They provided the Government with the opportunity to begin the process of change much more rapidly than usual. The reasons were plain to everyone. At the same time, we started a major educative programme to explain our objectives and the ways we intended to meet them. Understanding encouraged a feeling of solidarity, a good atmosphere in which to introduce a major programme of deregulation and restructuring.

The stockmarket crash two months after the 1987 election and its repercussions in the business and financial markets undermined sectional and popular confidence. Some of the expected short-term losses – rising unemployment, hard times for some in the farming and manufacturing communities, a drop in economic growth – now became apparent. By the end of 1987, there was also a public perception that the Government itself had lost its earlier momentum and was drifting. Our previous sureness of purpose and direction was less obvious. That loss of public confidence was understandable. It was taking longer to achieve the benefits of our policies that many had expected. And the Government was not explaining what it was doing, and why, as well as it had done previously.

Any government which plans major reforms must expect to be attacked. The need to keep reminding people of the objectives and the reasons behind the policy decisions taken to reach them is therefore much greater. In the midst of the day-to-day action, it is easy for the public and politicians to lose sight of the goals. If they do, they may end up opposing change even though their best interest lies in support and cooperation. A result of neglecting this aspect of government's dialogue with the people and with specific sectors since the latter part of 1987 is that those groups with vested interests are on the move again. They are seeking a return to bargaining that rests on special needs. They are looking at the short-term rather than the long-term interests of their members. They claim public interest, but this is in fact a mask for self-interest. It has been seen in the reactions of civil servants to the State Sector Act 1988 which provides a new framework for the reorganisation of the state sector. It has been heard in the protests of those who work in the public health and education areas when methods for improving efficiency, accountability and services were promoted.

In this sort of climate, when the air is thick with rhetoric, all cabinet ministers need to remind themselves that government is not about institutions or pressure groups. Ministers are often responsible for large public sector institutions and intensively lobbied by particular interest groups. That pressure comes with the territory; it is something a minister must understand. It is all too easy for the Minister for Housing to end up acting as the Minister of the Housing Corporation; or for the Minister of Aviation to become a Minister of domestic airlines.

The Housing portfolio is not about the Housing Corporation but about providing access to housing for those who need it. Similarly, what is the goal for our domestic airlines? Is it to protect Air New Zealand because we happen to own that enterprise; or is it about making sure New Zealanders get better and cheaper air services so that more people can travel and freight can reach the marketplace more efficiently? Should state organisations producing coal, timber and telecommunications have as their primary aim the employment of the maximum possible number of people; or should it be to be lean and efficient enough to contain costs for the consumer? In the latter case, industrial customers have a better chance to win markets, expand their operations and provide more jobs. So the real choice for government and ministers is this: fostering more jobs in specific areas such as aviation, coal mines or forestry, or helping to create new jobs through the *whole* economy.

It is not, after all, a minister's job to run a business. He or she is not qualified to do so. Nor should it be part of government's role to own businesses. The ministerial role, like that of government's, is to set objectives and then work out the best and most realistic solutions to achieve them. The primary responsibility is not to Air New Zealand or to the Housing Corporation but to the country as a whole.

As this Government began placing some state-owned enterprises on the market, there was a quite natural concern out in the electorate about who would now own assets which traditionally had been owned by the taxpayer. However, the alternative to that sale programme would be to continue carrying a vast debt – the current public overseas debt is $17.25 million, the total government debt $39 million or $11,000 per head of population. With daily interest payments of $12 million, this is an expense New Zealand cannot afford. It has meant that in 1988 the Government has had to spend $1000 million more on debt servicing than on education. A steady and significant reduction of that debt will free up money which can be spent in other areas, such as social policy.

A lasting reduction in debt can only be achieved, of course, if a country has an expanding and strong economy. A growing economy is also the only answer to unemployment; a government cannot create jobs simply by adding people to the state payroll. That kind of economy operates best when there is a substainably low inflation rate (achieved without resort to government controls); sustainably low interest rates; low personal and company tax levels; competitive cost structures; a productive workforce; and an attractive regulatory environment. We are now well on the way to attaining each of these objectives, further reason to withstand the pleas for a change of direction or a softening or slowing of the rate of change from sector groups.

There have been many people who have suffered real hardship during the economic adjustments of the past four years. That is an inevitable and unavoidable side-effect of major change. While the Government has been only too aware of their difficulties, we cannot in good conscience offer them the palliatives of the last twenty years with their known consequences. Businesses can no longer fall back on government to provide subsidies, protection from competition or guaranteed markets. They have to rely on their own skills, initiative, planning and drive. To revert to the old ways of managing the economy at this point would be to throw away the gains we have made.

There are a number of indicators which show that the economy is moving in the right direction. The first is inflation. Between 1974 and 1987, consumer prices rose by 432 percent. During that same period, the inflation rates in the United Kingdom rose by 244 percent, in Australia by 183 percent, the United States of America by 118 percent and Japan by 75 percent. Now, for the first time since 1973, the New Zealand inflation rate has dropped below 7 percent. At the end of December 1988, the annual overall increase in prices was 4.7 percent. As the inflation rate continues to drop, businesses find it cheaper to manufacture and produce goods which will be easier to sell locally and overseas. Business expansion opens up new employment opportunities. Given adequate consistency and credible economic direction, interest rates will continue to decline in line with inflation and rising confidence in a better future.

New Zealand's level of overseas debt is falling as a result of careful financial mangement and the Government's programme of asset sales. Last year, for the first time in 35 years, the Government began paying off some of the country's massive debt burden. This year it is intended to reduce overseas debt by a further $2,000 million. Changes in the value of the New Zealand dollar against foreign currencies has further reduced the public debt.

Productivity is growing, although there have been job losses and output is down in some areas. Increased productivity has occurred where industries have made substantial adjustments to meet the new environment. For example, in primary food processing, labour productivity has risen by 28 percent in the past three years. After the 1984 Budget, a number of people, including those in the Treasury, predicted a recession as a result of our disinflationary policies. In fact, since 1984, the economy has grown at an average of 2 percent a year. Export earnings are also at record levels. New Zealand had reduced its current account deficit from $2,932 million for the year to December 1987 to $389 million in the year to December 1988 – a remarkable achievement. Export values rose by 2.7 percent to $12,433 million; imports fell 1.6 percent in value to $11,608 million. June 1988 was the seventh successive month in which an export surplus was recorded. While the country's high level of debt has meant that the overall current account balance for 1988 is still $1.8 billion in the red, in recent months the balance has improved on average by $8 million per month.

This increase in the volume of exports does not back up the complaints of the farming and manufacturing sectors that the Government should reconsider its exchange rate policy and adopt a managed exchange rate. For some time now, certain groups of exporters have been complaining that the value of the New Zealand dollar has risen too much since it was floated in March 1985. In fact, the dollar has not increased markedly in value on a trade-weighted basis since March 1985. The real exchange rate, which is more important, was the same in the latter half of 1988 as it was in 1979 in United States dollar terms. If the exchange rate is too high, then the obvious question is what should it be – 44 cents, 49 cents, 50 cents? Why not aim for 25 cents? There was a time when it was worth $1.43 against the US dollar. Why then have we not benefited and prospered by that drop from $1.43 to 65 cents? Because while the farmers and exporters gained, the consumer lost as the cost of imports increased. The exchange rate is not a factor in isolation; it is a symptom of the real issues, of inflation and therefore interest rates. Attempting to "manage" it does nothing to solve the real problems.

Another indicator of the gains being made are the changes in the personal and company tax structures which took place in October 1988. They were a logical extension of the Government's intention to put fairness, efficiency and simplicity back into the taxation system. Equally, they are an incentive for the individual and for businesses. Personal income tax was reduced to 33 cents and 24 cents in the dollar. Low income earners are protected by a rebate. Business taxes were cut from 48 cents in the dollar to 28 cents, giving this country one of the lowest company tax rates in the world. This reduction followed a lengthy revision of company tax law which closed many of the loopholes and abolished special concessions. In 1987, the tax take from companies doubled as a result of these new rules. Under the new tax system it is forecast that companies will pay $2,380 million in tax in 1988/89, an increase of 95 percent over the previous year's total of $1,221 million. These changes have improved the Government's fiscal position and will allow companies to invest more in plant, machinery and jobs while continuing to contribute their share of the necessary tax revenue.

The regulatory and public sector reforms which have been instituted since July 1984 have been responsible for lowering the cost structure for the public and private sectors. Massive and undeniable waste occurs in state trading organisations and departments. Without significant changes in management and efficiency, services to taxpayers fail to keep pace with the growing amount of resources provided. Deregulation on many fronts has gone a long way to removing a hopelessly complex, inconsistent and unwieldy system of financial and commercial incentives and disincentives.

The effect of all these factors has been the development of a much more resilient economy. The gains have been made at a lower cost than for any other economy which has followed a similar path. One example of this is the cost to manufacturing productivity. There has been a 5.5 percent drop in output. At the same time, inflation fell by 7 percent. The loss compares very favourably with that of other countries which have fought inflation. When Canada brought inflation down by a similar amount, they lost close to 18 percent of their manufacturing output. Germany lost almost 10 percent to get inflation down by 4 percent. In France, a 5.5 percent drop in inflation saw a 10 percent fall in manufacturing productivity. The economies of these countries were not wrecked in the process.

In New Zealand, to change economic direction at this stage by reversing or relaxing present policies would bring no advantages in the short term because of the lags. There would be a loss of business confidence that would inevitably lead to higher inflationary expectations. Employers and unions would begin to act accordingly; only too soon the inflation rate would rise to meet their expectations.

The voices of the lobby groups have been joined more recently by those engaged in a growing debate about social and economic policy options. They include some who maintain, quite incorrectly, that decisions made early in the Government's first term in office forced it down one particular path. In reality, there was no alternative, coherent economic strategy for dealing with New Zealand's problems. There still isn't. Many of those who dislike the current policies can only offer slogans, favourite causes or pet hates rather than viable replacement policies.

One side of the debate on policy options favours a highly centralised approach where very detailed objectives are set for the nation as a whole and all its economic sectors. The state would decide how to allocate the physical, financial and human resources of the nation. It would fix the prices of all inputs and outputs, control all imports and exports, set the interest rates and fix the exchange rate. A high degree of compulsion would be imposed at every level of the community to achieve those objectives. The first problem with this option is that people do not give their best in such a rigid system — OECD studies show that better progress is made by nations which operate a more liberal system. The second drawback is our own experience of a similar system which proved that Big Brother does not know best.

At the opposite extreme of this debate is the so-called "new right". The new right thinks that if you are poor it is basically your own fault. They believe that the state does not make as good a use of its money as it could. The greatest success of the militant left and the new right is that they have been able to set the terms most of the community now uses to debate social policy issues. As the debate focuses on their distorted views of the means to achievement, the goals the Government sets for itself and all New Zealanders are forgotten: a better quality of life, jobs, pay, health, housing, education and security, and fair access for everyone to those benefits; a choice for people about the sort of life they want.

Good government should liberate people, not enslave them to either the private sector or the state. No one wants to be dependent on government for ever. Social welfare should not be about confining people to little boxes like battery hens for the rest of their lives. People need a genuine guarantee of dignity and security. Nor should they be penalised if things go wrong for them or if they lack the advantages of those more fortunate. Those who start behind the line need more opportunity and incentive, not less, than people who start with advantages. Government's responsibility is to open the future for people at every level. The alternative is beggars in the street and the rich living behind barbed wire.

Chapter 3

THE OPPOSITION ASSESSMENT

Simon Upton MP*

DISTINGUISHING ACTUAL OUTCOMES FROM THE explanations of those who fervently hope for confirmation of their forecasts is a tricky business only four years down the road towards liberalisation. This is true *a fortiori* for an opposition politician who has watched the process unfold from a niche which, by definition, has required a sceptical treatment of the evidence. So it is appropriate, at the outset, to acknowledge the considerable forthrightness which has accompanied many of the reforms undertaken since 1984; and important, too, to concede that the wisdom of hindsight is something not available even to the most inspired or committed politician. That said, it is time to stand aside from the euphoria that has gripped many descriptions of New Zealand's liberalisation experiment and to ask whether the gains are as substantial or as sustainable as are sometimes claimed.

It is fair to describe the reforms commenced in mid-1984 as an "experiment" on account of the sharp change of direction they represented for New Zealand and their novelty – particularly in the hands of a left-wing government and in an economy which was heavily regulated. A two-year wage/price freeze, extensive interest and exchange controls and growing cross-subsidies between sectors meant that price signals in the economy were severely distorted. There had been some deregulatory reform in the period prior to 1984 (most notably in the transport sector), but this had been at the periphery of an economy which had been increasingly straitjacketed as New Zealand sought to delay adjustments forced on it from without, particularly during the international dislocations of the mid to late 1970s. If the new Labour Government had a clear idea of the path it intended to follow, that was part of a hidden agenda: whilst there was growing frustration with controls and indifferent economic performance, there was certainly no widespread mandate for wholesale liberalisation. This was to prove an advantage in the early stages when the euphoria of change, coupled with the disorientation of vested interest groups

*Thanks are due to Charlotte Williams for her assistance in drawing togther material for this chapter and for her sharp critical eye.

likely to be opposed to change, allowed reform to proceed at a rapid pace. (Equally, when the country struck rough waters, particularly in the wake of the stockmarket crash of October 1987, the same absence of a mandate from within the Labour Party proved an increasing liability for a government faced with deepening recession and an alarming rise in unemployment.)

But the process bears the hallmarks of being experimental in another sense: rather than being an organic outgrowth of evolving policies, the changes to some extent sprang fully from the minds of the Government's advisors. New Zealand's Treasury had been building up a world view radically at variance with the populist orthodoxy of half a century. The Treasury's attempt to impose logical consistency and rational order on the market is captured in its advice to the incoming Government and published in its *Economic Management*.[3] The elements of the Government's programme were spelt out there from the very beginning. Although the grand scheme has not been comprehensively implemented in all respects, there must be few instances in our history when a government's instinct for reform has matched so closely the intellectual direction and urgency of its advisors.

The unique circumstances which led to the burst of reform from mid-1984 onwards make it possible to spell out the adjustment process as it was envisaged and then to measure the experience of its implementation against the theory. At the centre of the Treasury's critique was New Zealand's economic performance which, for more than a decade, had been lacklustre as the country sought to cushion itself from deteriorating terms of trade. The chosen adjustment path was seen as too slow; conflicting policy settings were claimed to have seriously distorted resource allocation and undermined sustainable recovery from the belt-tightening implied by the external shocks of the late-1970s.

The symptoms of this failure to adjust were held to be: mounting external debt (driven by persistent deficits in the balance of payments); a chronic internal deficit (caused by high public expenditure reliant on a narrow and eroding taxbase); and low economic growth caused by poor resource allocation. The last problem had been aggravated by the distortions of the wage/price freeze, which was a desperate response to loose monetary policies and hopelessly rigid wage-fixing mechanisms.

In advocating sweeping liberalisation measures, the Treasury sought to bring the external and internal accounts into balance (with an inevitable, short-run cut in living standards) and to base sustainable economic growth on the gains which allocative efficiency and price stability would confer. Inflation was to be targeted through a firm monetary policy; the current account was to be tackled through a substantial devaluation and fiscal pressure reduced by the removal of the subsidies to exporters which the devaluation made possible. Floating the currency as a means of gaining control of money supply was recommended, but the dangers of doing so in conjunction with a large fiscal deficit and a tight monetary policy were pointed out.

The theory spoken of a great deal in the new administration's first months was that a firm monetary policy would quickly dampen the inevitable price effects of devaluation and that exchange rate flexibility would compensate exporters for any erosion of competitiveness. Whilst the Treasury argued for labour-market deregulation to parallel the liberalisation of financial markets, the Government placed its faith for restraining a wage blowout in a tripartite accord. A short-run cut in national consumption was to be succeeded by export-led growth assisted by enhanced resource allocation at the microlevel.

It was a mechanistic prescription but propounded (at least in the early days) with such sobriety and rectitude that warnings of policy failure were not welcomed. In fact, for some considerable time, the coalition of interests supportive of the new environment was unable to distinguish criticism of the execution of the policies from criticism of their thrust. Policy malfunctions were glossed over. Only some way into the new Government's term were policy shortcomings to provide grounds for widely held concern. But shortcomings there were, and the tidy game-plan of 1984 was, not surprisingly, wide of the mark.

At the time of the change of government, the scene for quite strong growth had been set. Exporting industries, assisted by reduced labour costs during the freeze and a stronger world economy, were poised to capitalise on the devaluation of July 1984. To this was added an explosion of activity in a deregulated financial sector which commenced a period of rapid expansion. This was *not* a promising background against which to enter the first wage round in two years. The Government's attempt to find a tripartite (government, employer and union) consensus ended, predictably, in a stalemate. A hoped-for maximum of 4 percent was never in contention, as the bargaining rounds started at 7 percent and drifted up from there.

While these pressures were building up, the authorities were grappling with monetary policy. The desire to institute a tight monetary policy consistent with low or zero inflation was expressed repeatedly: the price effects of the devaluation were to be contained without prejudice to the trade sector. A firm monetary stance could not properly be attained until the currency was floated in March 1985, by which time loose conditions had already significantly stimulated consumption. Between March 1985 and the stockmarket crash in 1987, asset prices and an unparalleled stockmarket boom evidenced a monetary policy that was, to put it charitably, patchy. Inflation peaked at 17 percent in mid-1985 and, after declining to 10 percent in mid-1986, was pushed up again partially (but by no means solely) on account of a new 10 percent value added tax. A steep decline in the recorded Consumer Price Index was not apparent before the end of 1987. It is no surprise that, in these circumstances, wage movements remained excessive with the 1985/86 round breaking the 15 percent barrier.

Throughout the whole period, the fiscal front proved to be the Government's Achilles heel. Despite radical tax reforms (leading to a real growth in revenue of 40 percent in four years), expenditure still outstripped income. Any savings made by removing assistance to industry were eaten up by increases in other sectors. A dismal fiscal record coupled with strong inflationary expectations meant that monetary policy became the dominant instrument to drive the adjustment process. Very high nominal interest rates and an appreciating currency meant extremely difficult trading conditions for exporters, particularly those in the pastoral and land-based sectors where a high domestic product content meant that little advantage could be taken of the strong dollar. The promised automatic compensation for eroding competitiveness which a floating exchange was supposed to bring never eventuated. Whilst the prolonged adjustment process has meant that survivors are particularly lean and hungry, the element of burnoff caused by the protracted nature of the process is currently reflected in both rising unemployment and falling volumes in some key export commodities like wool.

Summarised, then, the first three years following the 1984 election can be characterised as a period of euphoric change during which serious inflationary, labour-market and expenditure problems were masked; in the wake of the October 1987 stockmarket crash, euphoria has turned to deep pessimism as the belated effectiveness of an anti-inflationary policy has struck a community devastated by a collapse in equity prices. Such a reaction was not the inevitable result of liberalisation policies *per se* but a probable consequence in view of problems in three key areas – monetary policy, labour market regulation and fiscal policy. Each of these three areas will be considered in turn.

1. Monetary Policy and the Fight to Contain Inflation

Between 1973 and 1984, New Zealand experienced recurrent bouts of inflation. In common with many other countries which had sought to cushion external shocks, loose monetary conditions were permitted so as to accommodate the wage and price effects of economic adjustments. The result was inflation. Attacking this culture was at the heart of the Treasury's agenda. From the outset, the new Government's stated policy was explicitly anti-inflationary. Monetary conditions had not only to be consistent with low or zero inflation: they had to be *believed* to be committed to non-inflationary ends. In advocating zero inflation in the medium-term, the Treasury spelt out the need for the Government to make up its mind about the objectives of

> monetary, fiscal and exchange rate policies for the immediate future. . .making sure that these are well understood and implemented in a credible manner so that employers and employees are not likely to agree to wage increases based on a mistaken view about Government policy intentions.[2]

Policy credibility was at the heart of a successful monetary policy. Whilst accepting that the devaluation would lead to an increase in the general price level, it was emphasised that this should be a once and for all adjustment rather than a permanent increase in the rate of inflation. The fact that low single figure inflation did not emerge until well into 1988 suggests that inflationary expectations were deeply rooted and the adjustment path more prolonged than it need have been. Was a defective monetary policy in part to blame for allowing inflationary expectations to run away?

On balance, the answer must be yes. By any standards, activity was far higher than a genuinely tight monetary policy would have permitted. For the calendar years 1985, 1986 and 1987, quarterly growth in M3 (the broadest measure of money supply) averaged 26 percent, 22 percent and 18 percent respectively. For the expansion of private sector credit over the same three years, average quarterly growth was even more spectacular at 31 percent, 27 percent and 18 percent respectively. Throughout this period, the Reserve Bank was quick to caution against reliance on such figures. Deregulation of the financial sector and the realignment of portfolios in the post-freeze era were bound to distort such broad aggregates. "Reintermediation" entered the language as an explanation for otherwise alarming figures. Such warnings were in order, but the authorities were themselves only finding their way in a new environment.

It seems fair to conclude that the operation of monetary policy was uneven to say the least. Preoccupation with defining and then refining the base measurement of liquidity for targeting purposes – primary liquidity – took time and, in the process, looser conditions than were desirable undoubtedly contributed to the boom in asset prices which should have alerted the authorities to earlier action. A threefold increase in Wellington central business district property values between 1985 and 1988, for instance, says something for inflationary expectations, as did the Barclays Index which, prior to the crash of October 1987, had more than doubled during that period. These prices coupled with high wage rounds and a CPI (Consumer Price Index) which stayed in double figures until mid-1987 suggest that monetary policy did not begin to bite until some three years after the adjustment programme commenced.

In one sense, not too much should be made of these problems in implementing a tight monetary policy. Much more visible failures on the wage fixing and public expenditure fronts were to disrupt the adjustment process. But it is fair to say that a looser than desirable (and looser than intended) monetary stance allowed pent-up forces in the economy to turn into an over-heated and damaging inflationary boom. Whereas a tighter policy would have choked off inflationary tendencies and preserved for exporters the competitiveness gains of the freeze and the devaluation, the policy-setting exposed them instead to high inflation and an appreciating currency as high nominal interest rates attracted offshore investors.

Monetary policy finally started to take effect in 1987 following the tightening of settlement cash targets and a rise in the discount rates. Ironically, the timing was such that when the stockmarket crash came in October, devastated confidence could not be underwritten through the monetary system for fear of derailing the disinflationary process. Relief in the form of falling inflation and interest rates and a moderation in the exchange rate did not come for nearly four years, by which time the effects of a "burn off" in the export sector were marked. The pain of disinflation was inevitable; the protracted nature of it was not. Had notice been taken earlier of the signals of damaging inflationary pressures, the ability of the export sector to spearhead a sustainable recovery would have been significantly enhanced.

2. Failure in the Labour Market

As New Zealand started down the liberalisation path in 1984, no market was more rigid or centralised than the labour market. At the time of writing (late 1988), that sclerosis persists, largely unchanged. Wages in New Zealand are set primarily through occupation awards which range across many industries and employers of widely differing sizes and economic circumstances. The result is a wage-fixing process which pays little regard to the ability of individual firms to pay and is driven very strongly by relativities between awards. It is, therefore, possible in the New Zealand context to give the outcome of a wage bargaining round in terms of a single percentage increase and thereby cover 90 percent of all awards.

The cornerstone of such bargaining practices is legislation providing for union registration which confers on unions the sole right to bargain on behalf of employees covered by awards within a union's industrial coverage. The former Government had moved, in 1983, to make union membership voluntary, but it left untouched the monopoly bargaining rights attached to union registration. This cautious reform was promptly reversed by the new Government, contrary to the tide of deregulation which it was sponsoring in other areas. Despite its reformist zeal, the Labour Government still found itself beholden to at least one large vested interest group – the union movement. By essentially underwriting the status quo, extremely uniform, rigid wage rounds were virtually guaranteed.

In an attempt to moderate the potential damage which a wage explosion could generate in such a straitjacketed system, the Government instituted a new tripartite conference to precede each bargaining round. Employers, employees and Government advisors were brought together to mimic rather more successful Australian attempts at negotiated wage restraint. The results over four wage rounds have been totally unproductive. No consensus or wage guideline has ever been achieved and, in most instances, the results of the wage round have generally been approximately double the Government's desired level.

Thus, in the first round commenced in December 1984, a hoped-for 4 percent increase in wages turned out at 7 percent for ten months, widening to nearly 10 percent by the end of the round. The second (1985/86) round proceeded on the basis that the Government would like no more than about 8 percent. In the end, the round commenced with settlements at the 15.5 percent mark with some reaching as high as 20 to 30 percent. A particularly high state sector award announced by the Higher Salaries Commission prior to the commencement of bargaining is generally blamed for the size of this round. The buoyant and inflationary prevailing environment, however, probably made the chances of a settlement as low as 8 percent slim.

The two subsequent rounds in 1986/87 and 1987/88 have exhibited the same rigidity at less spectacular levels, both averaging 7 percent. Despite repeated warnings that the world had changed and that catch-ups validated by cost-plus-pricing and loose money were no longer possible, wage settlements continued throughout the period to evince an inflation compensation rationale rather than one based on productivity. And, at least until 1987, the less-than-tight monetary stance described earlier managed to accommodate excessive pay increases despite intentions to the contrary. Now that industry has suffered a sharp deterioration in its competitiveness and a disinflationary monetary policy has been achieved, the predictable consequence of labour market failure – rising unemployment – has emerged.

The detailed problems of labour market adjustment are dealt with elsewhere in this book, but the conclusions to be drawn from the failure to tackle labour market rigidities are fairly clear: wage fixing on the basis of compensation for cost of living increases regardless of productivity can both lengthen the adjustment process and intensify the costs. In its briefing to the incoming Government in 1984, the Treasury had stated:

> . . . wage adjustments, however, to the extent that they go beyond what employers would have freely negotiated, jeopardise international competitiveness, the balance of payments and employment growth; on the other hand, to the extent that they are fully reflected in prices, wage increases imply *renewed* inflation.[3]

Wages during the liberalisation phase have not been freely negotiated. The award system coupled with direct industrial action ensured the continuation of wage bargaining according to the bad old rules. In addition to reduced business competitiveness and increased unemployment, fiscal policy became an additional casualty. Public sector pay picked up the trend of private sector awards with devastating results for a government which was already having difficulty holding the line on public expenditure.

3. The Fiscal Front

Reining in public expenditure is always difficult for a Labour government, given the expectations of its natural constituency. The new Labour Government's commitments, although vague, gave every hope of increased expenditure in the core social spending votes. But the size of the fiscal deficit which the new Government inherited made expenditure reduction inevitable, at least in the short term. The devaluation provided an opportunity for immediate - and easy - progress. Compensatory cross-subsidies to exporters could be removed as the *quid pro quo* for a more favourable exchange rate. The two main programmes to be discontinued were the Supplementary Minimum Prices (SMP) Scheme for key agricultural export commodities (worth $340 million in 1983/84) and export incentives to industry (amounting to $586 million in revenue foregone in 1985). As the Government's term progressed, a range of other less visible assistance measures were also removed so that by the 1988/89 Budget, net expenditure on transfers to industry had fallen 49.7 percent in real terms.

That sort of progress was not recorded in any other categories of expenditure - indeed, it was never a prospect. The seeds of disaster on the fiscal front were sown early and can be traced to three main causes. The first, already referred to, was the magnitude of the public sector pay increases in the break-out from the freeze. Since, in functional terms, personnel costs accounted at the time for over 18 percent of gross government expenditure, pay increases of the order of 11 percent in 1984/85 and 20 percent in 1985/86 added significantly to the Government's expenditure.

Even in 1987 when public sector pay-fixing reform to prevent upward drift was implemented the tide swept on. Anxious to bed down the new regime, the State Services Commission reached a 7 percent across-the-board settlement in the face of evidence that only 2.5 percent was necessary to align public and private pay.

Changes in the nature of the Public Service and relativities with a rapidly changing private sector made some larger than normal increases inevitable, but to the extent that public sector pay-fixing behaviour matched the overall national tendency to pass on adjustment costs, it contributed seriously to the undermining of fiscal restraint.

The second ominous pattern was the Government's penchant for trying to buy off problems through the tax system. In attempting to defuse the very first wage round, the Government introduced its "Family Care" income support package. Targeted at lower income breadwinners its annual cost was $390 million. It proved to be a poor investment. Hopes of a wage round in the region of 4 percent were quickly dashed as settlements started at 7 percent and drifted out to 9 percent. It was an expensive precedent, and subsequent trade-offs have meant that avenues for expenditure reductions have been steadily closed off. The introduction of a comprehensive value added tax (GST) in 1986 necessitated a substantial expansion of the Family Care scheme, now styled "Family Support". Income supplementation to offset fully the effects of the new tax on low- to middle-income earners cost $1 billion in the year of introduction and $750 million on an ongoing basis.

Spending the gains has become almost an article of faith for a Government which, increasingly, feels it cannot face its critics if expenditure cuts have been meted out. The recently announced changes to the administration of the education system (flowing from the Picot Report[4]) are a case in point. The Government has promised that the savings implicit in the Report (about $100 million) will also be spent elsewhere in the education system. If this is to be the price of expenditure reform, little progress seems likely.

The third weakness on the fiscal front flows directly from the last point – the Government's inability or unwillingness to tackle core public expenditure. Table 1 below spells this out for key functional areas of government expenditure over a four-year period.

Table 1 Real Change in Net Government Expenditure 1984/85 to 1988/89

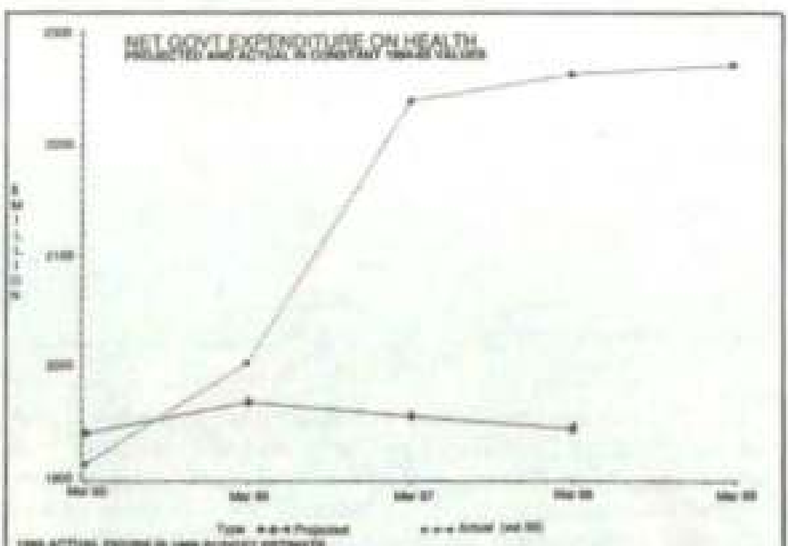
Social Services	27.5%
Health	18.8%
Education	26.3%
Administration	82.5%
Development of Industry	– 49.7%

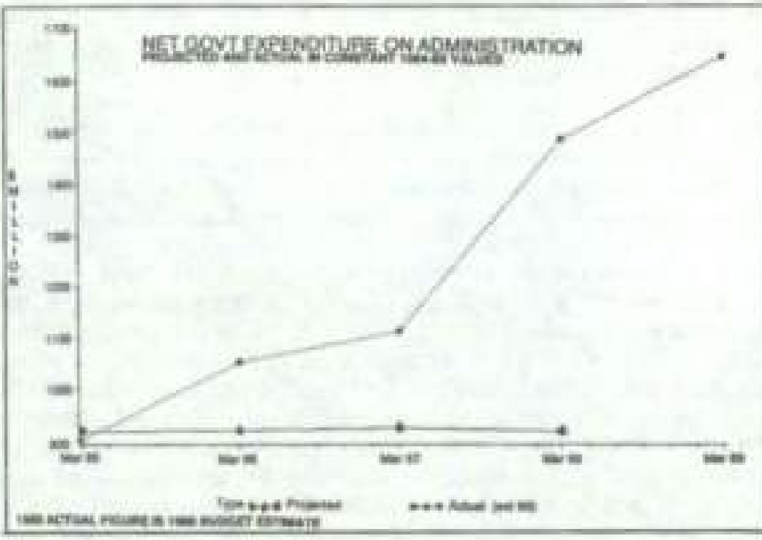
These *real* increases tell a story of serious failure to come to grips with the fiscal problems. At the time the Government took office, the Treasury had drawn attention to the fact that welfare expenditures had grown by 90 percent in real terms since 1970 but that there had not necessarily been an improvement in the output of services provided. In the simplified version of *Economic Management* made available by the Government for popular consumption, the matter was summarised very baldly in these terms:

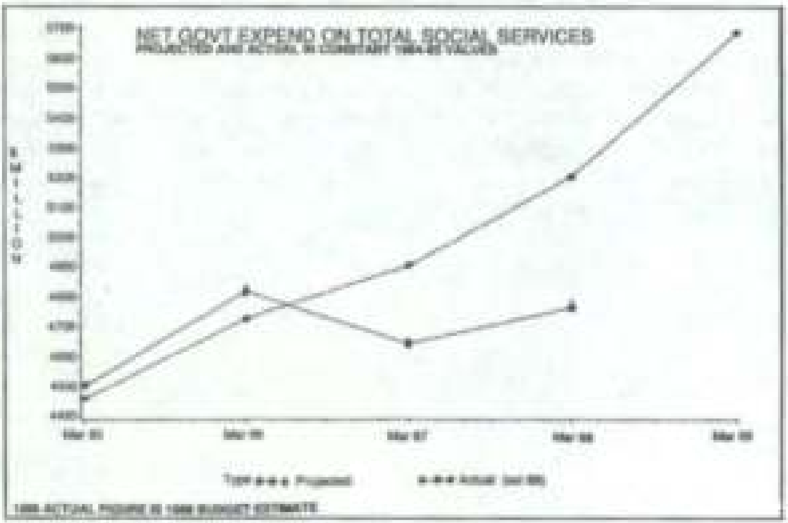
> Government expenditure on social services has grown spectacularly but the effectiveness of much of the spending is questionable. The state of the Government's finances offers little, if any, scope for increased spending on social services. We must get better value from our existing social services budget.[7]

In the event, the experience of preceding years was merely repeated with strong real growth in expenditure in the social services and administration areas. The nature of this paralysis was highlighted most clearly in the Government's response to the Report of the Hospital and Related Services Taskforce[8] chaired by Alan Gibbs. In recommending a radical restructuring of public sector hospital funding to achieve some "transparency", the Report suggested savings totalling $600 million could be achieved. Nonetheless, faced by a barrage of critics intent on maintaining the status quo (and a minister sensitive to his own future), the Government has allowed the Report to founder without a sponsor.

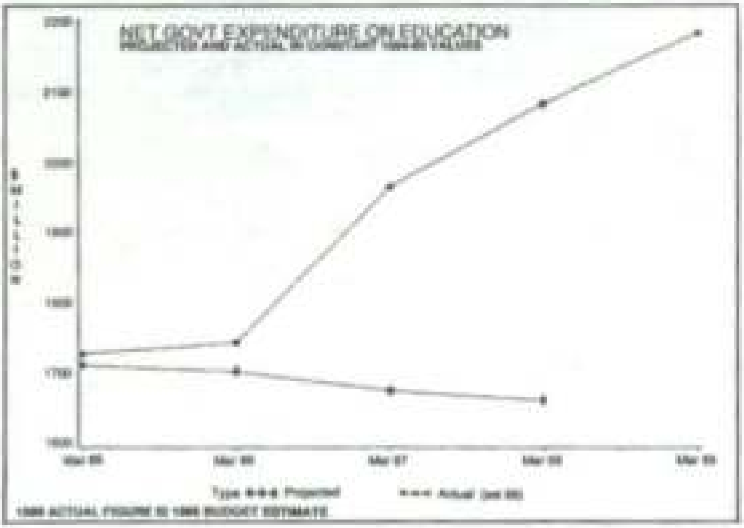
In 1985, the Government published fiscal projections to cover the three years 1985/86 to 1987/88. The projections were not intended as an accurate forecast but, rather, a baseline against which to measure performance. Figures 1 to 4 illustrate the extent to which intentions and practice diverged. The fact that such forecasts have not been repeated is in itself highly significant.







The Treasury and the Minister of Finance have continued to draw attention to the seriousness of problems on the expenditure side, most recently in the Annexes to the 1988/89 Budget. There, an effort was made to remove from the expenditure tables all those unusual or cyclical items which might distort the picture. Table 2 shows two measures of expenditure as a percentage of Gross Domestic Product,



both of which demonstrate an ongoing rise in public expenditure during these liberalisation years. Very simply, by whatever measure, the Government is spending more than it has ever done before.

Table 2 Net Expenditure Trends[1]

	($ million) 1984/85	1985/86	1986/87	1987/88	1988/89
Net Expenditure Table 2 (including expenditure on major project and producer board refinancing)	15,318	17,672	24,303	24,174	25,568
Adjustment Factors					
Less Item 1:					
Major project and producer board refinancing	—	—	3,358	1,058	2,300
Less Item 2:					
Net lending and asset sales	784	685	122	-1,709	-3,643
Net Expenditure (Financial Deficit basis)	14,534	16,987	20,823	24,825	26,911
(As a percentage of GDP)	37.4	37.9	39.0	41.4	42.6
Less Item 3					
The effect of tax reform measures					
Taxation of benefits	—	—	119	261	300
Family Support[2]	—	—	101	211	127
GST on expenditure	—	—	406	1,024	1,110
FBT — on expenditure	—	11	14	18	19
— on superannuation subsidies	—	—	—	—	121

Continued Table 2

Table 2 Net Expenditure Trends[1]

	($ million)				
	1984/85	1985/86	1986/87	1987/88	1988/89
Less Item 4					
Employer superannuation subsidy payments	—	—	—	176	301
Less Item 5					
Reorganisation of the public sector	600	350	625	725	425
Less Item 6					
Debt servicing	2,563	3,340	4,092	4,971	4,575
Less Item 7[3]					
Unemployment benefits	275	291	460	673	1,009
Net Expenditure less Adjustment Factors	11,096	12,995	15,006	16,846	18,924
(As a percentage of adjusted GDP[4])	28.6	29.0	28.7	29.6	31.8

Notes:

[1] Explanation of each item is expanded in the text.

[2] Total Family Support less an estimate of family assistance paid to beneficiaries that was previously paid through Vote : Social Welfare.

[3] Excludes tax component of unemployment benefit payments.

[4] GDP less the impact of the introduction of GST, as outlined in Annex 3.

Sources:

- Net lending and asset sales figures – GFS data and Treasury estimates.
- All other data – Budget Table 2, and Treasury estimates calculated on a Budget Table 2 basis.
- Nominal GDP – Department of Statistics estimates to 1986/87 and Treasury forecasts for 1987/88 and 1988/89 of $60,100 and $63,100 million respectively.
- Adjusted GDP – Treasury estimates, contained in Annex 3.

Table reproduced from *Annex to 1988 Budget*, p. 20.)

Not surprisingly, this record could only have been possible in an environment which allowed for rapid gains on the revenue side. There can be no doubt that taxation has been the Government's key "success" story. In real terms, total revenue from taxes has risen by over 30 percent since the adjustment process commenced. The single biggest new component came from the new Goods and Services Tax (GST).

A tax on non-wage benefits (the Fringe Benefit Tax) was also introduced, and rafts of exemptions and deductions for business were removed or phased out. Much of this was done in the name of closing "loopholes" and achieving tax neutrality, but from a business point of view it has simply meant higher effective tax rates. Only comprehensive capital taxes remain unimplemented, although they are on the agenda and, given the unaccountable enthusiasm for them of so many professional advisors, seem likely to come to pass.

This dramatic broadening of the tax base was made politically sustainable through cuts in the very high marginal rates of tax on wages and salaries which had obtained until 1984. The top marginal rate of income tax has fallen from 66 cents to 33 cents, and the rate of company tax from 48 cents to 28 cents. Whilst the positive incentive effects of these lower rates is to be applauded, the overall picture is one of mixed blessings. For many, the new taxation environment has meant higher effective rates of tax. And, for most citizens, fiscal drag has obliterated the benefits of lower nominal tax rates. Over the four years 1984 to 1988, the average rate of tax on wages and salaries remained much the same, at around 26 percent. The net effect of an aggressive move to broaden the tax base is thoroughly unsurprising: the tax burden has increased. The Treasury drew attention to this in its 1987 advice to the re-elected Government. Table 3 pulls together the consequences for taxation of rising expenditure levels. No amount of tax reform can lead to a lower incidence of tax if demands for expenditure continue to grow.

Table 3 Expenditure Trends and Tax Burdens[3]

	1973/74	1979/80	1984/85	1986/87	1987/88
Total Expenditure ($m)	2,857	7,954	16,938	22,829	25,592
% of GDP	(31.1)	(40.4)	(43.8)	(43.6)	(43.7)
Less Net Lending	243	616	784	122	-1,649
Less Departmental Receipts[1] ($m)	62	148	349	929	2,263
Less Tax Reform Measures[2]			570	1,545	
Adjusted Expenditure ($m)	2,552	7,190	15,805	21,208	23,433
% GDP	(27.8)	(36.5)	(40.9)	(40.5)	(40.0)
% Private Income	(29.4)	(34.8)	(39.6)	(41.6)	(42.7)

Notes:

[1] Departmental Receipts are the sum of administrative fees, charges and non-industrial sales; fines forfeits; and other non-tax revenue.

[2] Source: Annex 2 of the 1987 Budget.

[3] Note that no allowance has been made for the phase-out of tax expenditures.

Sources:

Government Financial Statistics (GFS) data. Nominal GDP-Department of Statistics estin and Treasury forecasts. Private Income – Treasury estimates and forecasts. (Table taken from *Government Management*. Vol. 1. The Treasury, Wellington 1987, p. 228.)

In summary, the liberalisation process has been seriously impaired by an unwillingness to tackle public expenditure. In fact, there has been an indulgent attitude towards some areas of public expenditure, and particularly social services, as a *quid pro quo* for reforms in other areas. Ministers in the social arena have managed to spend money faster than even a 30 percent increase in the tax take would allow for. This is where the nation has suffered its most serious lost opportunity.

It is instructive to try to assess what the outcome would have been had the Government possessed the resolve to do no more than maintain social expenditure in real terms, as well as to holding spending in the other major categories of Foreign Relations and Government Administration. Its ability to retire debt and reduce debt servicing costs could, on certain rather stringent assumptions, have put it in a position by Financial Year 1989 to run a substantial financial surplus of as high as about $5 billion, or 8 percent of GDP. This could, in turn, have been applied to retiring debt. But even if these assumptions were relaxed to take account of such things as the cost of rising unemployment or of state sector restructuring, the rather "broad brush" calculation still illustrates the point.[7] The Government's fiscal policy has been conducted in such a way that an opportunity to lighten New Zealand's public debt burden has been allowed to slip by.

As it is, New Zealand's public debt level is still high by international standards and very high by OECD standards. Too high a level of public debt threatens the Government's financial stability and in times of economic downturn limits its room for manoeuvre. It siphons off in tax private sector resources that could otherwise be turned to more productive account. Moreover, the high proportion of debt in foreign currencies exposes the Government's finances to serious risk from a depreciation of the New Zealand dollar. Retiring debt is, therefore, a priority, particularly when renewed growth in the economy, on which debt servicing can be based, is so elusive.

The failure to tackle public expenditure sufficiently vigorously to reduce the debt burden represents a most serious omission in the Government's programme for economic recovery. The lost opportunity which fiscal failure represents means that the thrust of the Government's ambitious privatisation programme is increasingly controversial. Although privatisation is not central to this account, it should be noted that the scale of the privatisation programme (and the extent to which state-trading departments have been corporatised) is one of the most remarkable features of the whole liberalisation process. The rationale for corporatisation followed by privatisation has been presented largely on efficiency grounds: that although it might be argued that there is no reason why state-controlled activities should be inefficient, experience tells us that exposure to market forces with consequence efficiency gains and pressure to rationalise is best achieved through private ownership.

This line of reasoning has received less emphasis in recent times as ideological opposition to privatisation has reared its head. The Government has, instead, chosen to explain the programme in terms of the imperative of reducing public debt. To the extent that asset sales will not improve the nation's balance sheet, this is a specious argument. But in terms of reducing the stock of debt held by the Government (and having that debt managed by a more efficient private sector), there are probably useful gains to be made. The problem is that ongoing fiscal deficits mean that asset sales are being used, indirectly, to bridge the shortfall in the Government's accounts. To the extent that any breathing space gained by reduced debt servicing costs is used to boost spending elsewhere, the New Zealand Government is simply on a treadmill of realising assets to fund excessive current consumption. And that excessive consumption continues to fuel growing debt as balance of payments deficits mount year by year. Such a strategy is not only financially imprudent but is also likely to undermine any public mandate for privatisation which, far from being seen as a key to popular share ownership (as in the United Kingdom), becomes a crude asset-stripping exercise in which a government sells publicly owned assets to finance its own politically motivated spending programmes. Fiscal pressures may well also mean a faster disposal of assets than would otherwise occur, leading to a bad deal for taxpayers.

The Future

After four years of frenzied change two questions hang over the liberalisation experiment: can reforms implemented to date be maintained, and will deregulation be extended to new areas? The bulk of the liberalisation measures is irreversible, at least for a generation. To a large extent, these measures have assisted the integration of a small, highly protected country into the international economy. The price of retreat from a much more outward-looking society spearheaded by the opening of New Zealand's capital markets would be too high for a nation which has an appetite for the living standards that much wealthier countries enjoy. In any case, fortress economies are virtually unthinkable in the present international environment (trade wars aside).

But there is a risk that, if further changes are not made, New Zealand's economy (and social structure) could divide into two: a dynamic, internationally competitive and outward-looking external sector, and a frustrated welfare-dependent and largely inward-looking rump. The possibility of this stems from the failure to produce a more flexible labour market (both regionally and for enterprises) and a total failure to tackle state-induced dependency.

To some extent, the Government has to date placed much of the pressure of adjustment on the trading sector whilst defending the living standards of large numbers of dependants, as well as adding thousands of working families to their numbers through income support schemes. A rationale is not hard to construe: since the exposed sector of the economy is going to have to underwrite living standards through greatly improved profitability, then the sooner it can survive on its own, the better. This, of course, begs the question of the extent to which the exposed sector's profitability can ever be viewed independently of the economy and society at large. There is also the implication that if the wealth-producing sector of the economy can perform adequately, will the Government be able to claim through taxes the share of that wealth necessary to support the population at large?

It remains an open question whether or not it is possible to build a society in which an exposed and ruthlessly efficient sector is used to fund a protected and insular population. This Swedish-style scenario sees liberalisation as a means to an end: better economic performance to generate wealth for a heavily redistributive state. For those who favour a more self-reliant social fabric and believe that entrepreneurial dynamism requires an entrepreneurial culture, this is, of course, anathema. It is a case of harnessing the market for redistributive ends, with serious consequences for incentives and, ultimately, individual liberties. Even if a Swedish approach were explicitly advocated, the question remains whether New Zealand could hope to keep the physical and human capital necessary for its attainment. Integrating New Zealand with the world economy has meant a significant surrender of political sovereignty. The ability of New Zealand to run tax regimes substantially at variance with prevailing codes abroad has been reduced. Enforced international harmonisation will eventually apply to all government programmes. Essentially, New Zealand will find it increasingly difficult to run social programmes that are substantially more generous than those of its trading partners – it has neither the productivity nor the industrial base to afford them.

Finally, it is inconceivable that attitudes in New Zealand, which are still heavily imbued with a cradle to grave welfarism, can remain unchanged in New Zealand's fight for survival in a much more competitive world. Whilst economic integration with Australia through Closer Economic Relations may provide some respite, the desirability of a larger population base through immigration is likely to see traditional values threatened. Certainly, removing controls on the movement of capital has given citizens the freedom to vote with their feet.

If there is an element of the Government's agenda to date which is in danger, it must be the privatisation programme. There is a broad political consensus for privatisation of state-owned entities. What is contentious, however, is the question of foreign ownership of those assets. Governments in other parts of the world have sought to popularise such programmes by creating a constituency for individual share ownership in the population at large. The speed of the Government's programme and the small size of New Zealand's domestic capital market have made foreign placement more likely. A decision to sell the state-owned gas and oil developer, Petrocorp, to British Gas foundered on a groundswell of xenophobic reaction, and the company was eventually disposed of to a major New Zealand corporate. It was both an indication that the public held real concern for economic sovereignty in key areas and a warning to the Government about the handling of future sales. Very little has been done to "sell" the benefits of privatisation and, by adopting a ruthlessly clinical approach, the Government may well have created the potential for a serious backlash.

The other cloud on the horizon for the liberalisation experiment comes from a quarter wholly unexpected four years ago. New Zealand is now preoccupied with a major debate over the status of New Zealand's indigenous people, the Maori, and their rights under the Treaty of Waitangi which ceded sovereignty to the British Crown in 1840. The freemarket ethic is one which tends to be indifferent to cultural politics, and the potential for extensive resource claims on behalf of Maori inevitably creates uncertainty. Already, the Government's plans to privatise the assets of large state entities have run into serious trouble from land claimants. This is an issue that will not go away and, although not directly related to economic management issues, actually has the potential to preoccupy (and even paralyse) decision-makers.

And in that there is considerable irony. Much of the Government's thrust has been to remove political constraints from markets so that resources flow to the areas of highest return rather than the areas of greatest political benefit. Now an issue has raised its head which is purely political – an issue of sovereignty and nationhood. A government that has won a considerable following for breaking old moulds in economic management suddenly finds itself seriously ill-equipped to cope with a truly political issue. As this and other issues start to emerge, politics will, in all likelihood, once more slowly invade the economic agenda.

However, the centre of gravity in economic debate has, short of a catastrophe, shifted irrevocably. In this, New Zealand is merely following the rest of the world. But, as is so often the case with this distant antipodean land, intellectual currents tend to arrive late and in a particularly undiluted form. With the exception of New Zealand's uniquely indigenous issues of race and nationhood, the next big shift is likely to be externally generated. The shrewd observer will be monitoring shifts in the intellectual climate abroad in assessing the durability of New Zealand's domestic economic framework.

Notes

1. The Treasury, *Economic Management*, Wellington, Government Printer, July 1984.
2. Ibid. p. 141.
3. The Treasury, op. cit.
4. *Administering for Excellence*. (The Picot Report) Department of Education, Wellington, 1988.
5. The Treasury, *Economic Management*. (Pamphlet version) Wellington, 1984.
6. Hospital and Related Services Taskforce. *Unshackling the Hospitals*. (The Gibbs Report) Wellington, 1988.
7. Any analysis of this nature is bound to be rough and ready, and the figure thrown up can give an impression only of the impact on the Government's finances of any given degree of fiscal restraint. The effect of the estimated savings on the debt burden and servicing costs is calculated using the following assumptions which naturally reflect the wisdom of hindsight:

   a) the maintenance of government expenditure in real terms where otherwise real increases occurred;

   b) the maintenance in real terms of reductions in government expenditure since 1985 where these occurred, thus removing any subsequent real increases;

   c) applying any resulting savings to retiring debt.

Note: Actual government revenues were used.

Chapter 4

FINANCIAL POLICY REFORM

Grant Spencer and David Carey*

FINANCIAL DEREGULATION AND CHANGES in monetary policy and exchange rate policy over the past four years have occurred within a broad package of economic reform policies aimed at increasing sustainable living standards in New Zealand. In common with reforms in other sectors, deregulation in the financial sector has involved abolishing legal restrictions or practices that prevented price signals from accurately conveying to market participants the economic costs and benefits of their actions. Where continued government intervention has been deemed necessary, reform has been aimed at making that intervention as efficient as possible.

The principal financial reforms made in New Zealand since July 1984 are reviewed in this chapter. The review begins with a brief outline of some of the major problems facing the economy in 1984 and how the financial policy framework of the time had contributed to the development of those problems. The main financial reforms are then outlined, together with the rationale underlying their adoption. A discussion of the consequences of the reforms follows. This discussion raises the issue of the optimal sequencing of reforms within an overall liberalisation programme, and this issue is addressed in the final section of the chapter.

1. Background

Although there were short-term economic problems facing the new Government in 1984 that required immediate action, the more serious difficulty to overcome was the general malaise that had afflicted the economy over a long period. Since 1960, average annual growth in New Zealand's per capital GDP had only been 1.4 percent, by far the lowest of any OECD country and approximately half the OECD

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average over this period (see Table 1 and Figure 1). As a result of this slow growth, New Zealand's per capita GDP fell from seventh highest in the OECD area in 1960, to fifteenth highest in 1970 and to eighteenth highest in 1984. Over the same period, New Zealand's average inflation rate was 8.5 percent, significantly higher than the total OECD average of 6.3 percent.[1] (See also Table 1.)

During the decade ended in 1984, New Zealand's relative economic performance was even worse. There had been virtually no economic growth, current account deficits reached record levels and inflation was extremely high, only being suppressed towards the end of the decade by a wages and prices freeze. No other OECD country fared as badly over this period.

In addition, New Zealand's external public debt had grown to uncomfortably high levels by 1984. The external debt of the official sector plus government corporations plus the "Think Big" projects had increased from 10.7 percent of GDP in March 1975 to 35.4 percent in March 1984. Moreover, the extent of this increase was understated by a real exchange rate that was widely perceived to be overvalued; without any further external borrowing, the 20 percent devaluation of July 1984 rescaled the government external debt to GDP ratio up to 45.9 percent.[2] This growth in the Government sector's external debt was of concern because the debt had largely been accumulated to support high levels of national consumption expenditure and to finance energy projects of dubious economic merit. Consequently, there was little or no prospect of an increase in investment income that could help to service the debt.

Table 1 Key Economic Indicators

	1960-1984		1974-1984	
	N.Z.	Total OECD	N.Z.	Total OECD
GDP per capita[1]	1.4	2.7	0.3	2.0
Current Account Balance/GDP[2]	-2.9	0.0	-4.8	-0.3
Inflation Rate[3]	8.5	6.3	13.4	8.8

Notes:

[1] Average annual percentage change.

[2] Average percent.

[3] Average annual percentage change in Consumers Price Index.

Source:

OECD *Economic Outlook*. Historical Tables, 1987.

Contributing to these problems was a range of government economic policies that distorted relative prices in New Zealand so that individual households and firms could not make economic decisions based on the full costs and benefits to the nation. Important distorting non-financial economic policies included (highly variable) industry assistance, state enterprise output pricing that often did not reflect production costs and acceptance of restrictive labour market practices. The Government's financial policies also distorted relative prices, in particular by artificially discouraging net savings (that is, savings net of domestic investment expenditure) in New Zealand and by encouraging investment in some activities at the expense of others. Financial sector reform was thus regarded as an important component of an overall liberalisation strategy to increase sustainable income levels in New Zealand.

In a variety of ways, expansionary monetary policies had undermined the efficiency of resource allocation in New Zealand. First, these policies had contributed to high and variable inflation rates. Such inflation distorted resource allocation directly by increasing the volatility of relative prices and clouding the distinction between general and relative price movements. High inflation also distorted resource allocation indirectly through its interaction with a nominal-based tax system. Investment in appreciating real assets, such as commercial buildings, was artificially encouraged by the combination of the non-taxation of capital gains (which largely reflected the effect of inflation) and the full deductibility of nominal interest payments (which were largely repayments of the real capital borrowed). The nominal tax treatment of interest in an inflationary environment also discouraged savings by lowering after-tax real rates of return to low negative values.

Second, through their interaction with exchange controls and a fixed exchange rate, expansionary monetary policies artificially encouraged domestic investment expenditure and discouraged domestic saving. Expansionary monetary policy in an exchange control/fixed exchange rate environment had this effect because domestic savers were prohibited from shifting their funds offshore to take advantage of higher foreign real interest rates, thus preventing any automatic offset to the liquidity expansion via a private capital outflow. With New Zealand tending to run an easier monetary policy than those of its major trading partners, domestic real interest rates were thus kept low relative to world levels. As a result, spending was encouraged and saving discouraged, leading to an expansion in aggregate demand relative to national income and a worsening in the current account deficit.

Had the exchange rate been floating, part of this pressure would have been reflected in a lower nominal exchange rate. Under an administratively controlled exchange rate, however, the dis-saving was fully felt in the current account deficit, and with no prospect of private capital being attracted into the domestic market, large and ongoing official capital inflows were required to fund the persistent current account outflows. As a direct consequence of this borrowing, the Government accumulated $13 billion of official overseas debt over the decade to mid-1984.

In this manner, official overseas borrowing effectively supported an artificially low domestic interest rate structure by making good the domestic shortage of savings at those interest rates. In doing so, however, economic efficiency was compromised. Private sector investment decisions were being made on the basis of real interest rates that were lower than the real rates being paid by the Government on foreign capital markets to effectively fund this investment. The public thus was encouraged not only to over-consume but also to over-invest at marginal rates of return below the real cost of foreign funds. Consequently, the nation's net worth, and hence the level of sustainable national income, both continued to decline relative to their potential levels.

As previously noted, the gap between aggregate demand and aggregate income (that is, the current account deficit) was greatest during the decade to 1984. Governments had responded to the two major declines in the terms of trade that had occurred over this period by operating expansionary monetary and fiscal policies and by funding the resulting current account deficits through offshore borrowing. The initial aim of this policy had been to shield the domestic economy from the downturn in national income until the terms of trade recovered again. This policy was favoured on the grounds that unnecessary and costly structural adjustments in the economy would thereby be avoided. Unfortunately, the terms of trade did not recover again but rather continued to decline. The Government, however, did not discontinue its expansionary macroeconomic policies once it became clear that a long-term decline in the terms of trade had occurred; this stance simply delayed the structural adjustments in the economy that had become necessary. In particular, the maintenance of high levels of aggregate demand supported a buoyant non-traded goods sector while exporters faced more depressed market prospects. The combination of an administratively controlled nominal exchange rate and a relatively high rate of price inflation meant that the real exchange rate was not able to depreciate significantly and thereby encourage the transfer of resources from the non-traded to the traded sector. Some attempt was made to compensate for the strong real exchange rate through a range of export subsidies and incentives. However, the concentration of these on the traditional pastoral products (in particular through the Supplementary Minimum Price Scheme) meant that structural responses to changing rates of return within the traded goods sector were forestalled. In this way the adjustments necessary to achieve a sustainable external balance were being deferred.

Expansionary monetary policies were not the only policies that distorted the level and distribution of savings over this period. Lending directive ratios required financial institutions to allocate a certain proportion of their lending to favoured activities, regardless of the profitability or riskiness of investment in these sectors. Interest rate controls were intended to contain interest rates but also had the inevitable consequence of diverting a greater than usual proportion of funds to low-risk borrowers and investment projects. To the extent that these controls were binding, they helped to ensure that savings resources did not flow into projects with the highest risk-adjusted earnings.

Pre-1984 government financial policies also reduced sustainable national income levels by lowering the efficiency of financial intermediation services. Interest rate controls and compulsory ratio requirements encouraged the development of less efficient fringe financial intermediaries that were subject to less onerous controls. As a result, intermediation services were more expensive than necessary. The non-contestability of banking may also have made banking services unnecessarily expensive.

In view of these problems, it was apparent that financial sector reform would be an essential part of the overall medium-term economic strategy to overcome the country's economic problems. An anti-inflationary monetary policy was required, and a liberalisation of government interventions and restrictions on financial markets was needed to promote efficiency within financial markets and a better distribution of financial and real resources among alternative uses.

2. Financial Sector Reform: 1984-88[3]

Abolition of Interest Rate Controls

During the early stages of the reform programme, the agenda was strongly influenced by the circumstances surrounding the election of the Government in July 1984. The foreign exchange crisis necessitated an immediate and substantial devaluation together with the abolition of across-the-board interest rate controls.[4] These measures were necessary to enhance the attractiveness of New Zealand dollar assets and thereby halt the foreign exchange outflows experienced over the previous month.

Although the abolition of interest rate controls was timed to coincide with the devaluation, there were strong economic arguments that would have warranted making this reform even if there had been no foreign exchange crisis. The removal of interest rate controls was expected to lead to a better balance between private savings and investment and an improved distribution of savings by enabling borrowers with the highest earning projects to successfully compete for funds in the marketplace. The efficiency of financial intermediation services was also expected to improve as the most efficient intermediaries similarly found themselves able to increase their market share.

In addition, with the confirmation that quantities of money and credit could not be controlled at the same time as interest rates, the abolition of interest rate controls became a necessary precondition for an effective disinflationary monetary policy. From mid-1984 onwards, monetary policy settings were progressively tightened and the Government followed a public debt policy of fully funding net public sector injections to the reserves base of the financial system through sales of medium- to long-term debt. Reflecting the removal of controls and the tightening of policy, interest rates on short-term (six months to two years) government debt rose from 9.8 percent in May to 17.3 percent by December 1984.

Exchange Rate Float and Abolition of Exchange Controls

Once interest rate controls had been removed, it was recognised that an effective disinflationary policy could potentially be implemented under a fixed exchange rate regime. Provided that an exchange rate peg could be maintained, domestic inflation would eventually settle at the level occurring in New Zealand's trading partners. However, it was also recognised that the adjustment path under a fixed nominal rate could be very disruptive, with the potential for an initial soft period of low real interest rates, followed by a tight liquidity squeeze as foreign investors eventually became reluctant to continue financing the nation's savings imbalance. Indeed, the experience of the December quarter 1984 demonstrated that, with confidence in the exchange rate peg, private capital flows could very easily offset any attempts by the authorities to tighten domestic liquidity conditions. In order to maintain an independent and consistently firm monetary policy, it was clear that the exchange rate would have to be floated.

It was also recognised that, to ensure as successful a float as possible, exchange controls should be removed so as to allow the development of the deepest possible foreign exchange market. Stabilising speculation was considered to be extremely important for a small currency subject to seasonality in the pattern of its export receipts. With the aim of floating the exchange rate in mind, exchange controls where abolished in December 1984. A clean float of the exchange rate followed in March 1985.

In view of the distortion that exchange controls had imposed on the level and uses of savings prior to 1984, a further objective of abolishing exchange controls was to achieve a better distribution of savings, as well as a better balance between national savings and investment. In the absence of exchange controls, it became considerably more difficult for governments to pursue lax financial policies with the aim of maintaining aggregate demand above national income. By implication, it also became more difficult for governments to indefinitely defer adjustment to declines in the terms of trade.

The external discipline on monetary and fiscal policies was also enhanced by the increased transparency of policy. With no exchange controls, a loose monetary policy in a fixed rate environment would generate large private capital outflows and possibly a currency crisis. Under a floating exchange rate regime, the same policy would produce a depreciating exchange rate and high inflation. Similarly, a lax fiscal policy would be evident in the pressure applied to domestic capital markets; it could no longer be disguised by the capture of domestic savings at below market interest rates. These effects of loose financial policies, being highly visible, made it more likely that Government would quickly be called to account.

Similarly, the float of the exchange rate was expected to give other benefits apart from an effective monetary policy. An important aim of the exchange rate float was to facilitate future real exchange rate adjustments with less adverse output and employment consequences than would probably be encountered under a fixed exchange rate.[8] While a real exchange rate appreciation can be easily achieved under a fixed rate regime via an inflation rate above that of the trading partners, a real depreciation must occur through a reduction in domestic inflation below foreign inflation. Thus, if prices are not perfectly flexible, output and employment losses are likely to occur as domestic inflation is pushed below foreign inflation for the period required to achieve a real exchange rate depreciation. These output and employment losses are avoided under a flexible exchange rate regime, provided that unions are prepared to accept the real wage cuts caused by higher prices for traded goods.

Of course, New Zealand's "fixed" exchange rate was not truly fixed. So as to achieve and sustain some of the real exchange rate depreciation that had become necessary following the downturn in New Zealand's terms of trade during the 1970s, periodic depreciations of the nominal exchange rate were made. Furthermore, over the period 1979-82, any real appreciation was limited by a crawling peg exchange rate policy that entailed continuous downward adjustments of the New Zealand dollar in line with the differential between domestic and trading partner inflation. However, the Government and its advisors had difficulty assessing when and by how much the exchange rate should be depreciated in excess of the inflation differential. Moreover, because governments had tended to delay depreciating the nominal exchange rate until pressures from private capital outflows became overwhelming, foreign exchange losses were often incurred. These losses were most extreme in June/July 1984 when $746 million of public funds were lost to the defence of an overvalued exchange rate. The desire to avoid further taxpayer-funded foreign exchange losses was an important reason for moving from a fixed to a floating exchange rate regime.

Abolition of Ratio Requirements and Credit Guidelines

Another important aspect of the financial regulatory environment that required overhauling was the requirement on financial intermediaries to comply with various government security ratios and other balance sheet restrictions. These ratio requirements, which varied enormously between institutional groups, had been imposed over the years with the intention of providing government with cheap funding, of ostensibly achieving monetary control with relatively muted interest rate consequences, of directing resources to favoured activities through housing/farming/local authority investment ratios and, again ostensibly, of improving the prudential soundness of financial institutions. Credit growth guidelines were also imposed on the major institutional groups over the 1982-84 period, with the aim of controlling money and credit growth in the absence of market-determined interest rates.

Ratio controls did impose an effective tax on the specified institutions by forcing them to buy government securities earning non-competitive interest rates. The other objectives were not, however, met. Although the ratios on all financial institutions could have been used more actively for monetary policy purposes, in general only the trading bank reserve asset ratio (RAR) had an activist monetary policy aim. More frequent use of ratio adjustments was made during 1982-84, including the use of a marginal ratio on finance companies in 1984; however, the other ratios generally remained fixed for long periods. While ratios in general and RARs in particular were capable of applying a marginal easing or tightening of liquidity conditions, they did not have the capacity to exert a sustained independent influence on monetary conditions: first, institutions could manage their level of reserve asset holdings simply by trading in government securities in the secondary market; second, any pressure applied through ratios tended to promote a redirection of financial intermediation services away from the specified institutions. This process of disintermediation effectively undermined the impact of a policy tightening on the broader money and credit aggregates. The main lesson learnt was that any influence to be applied through ratios would be felt through interest rate pressures. Thus, if the interest rate consequences of a tight monetary policy could be tolerated, there was no additional monetary policy gain to be had through ratio controls.

Ratio controls may have increased the proportion of lending to favoured sectors by the institutions subject to the sectoral lending ratios, but may not have contributed greatly to the overall quantity of funds lent to these sectors. The financial intermediaries that were not subject to lending ratios were able to earn a better return on funds than the restricted institutions, and were therefore able to attract a greater share of available deposits. Hence, the controlled institutions may well have lost market-share to the extent that total lending to the favoured sectors was no higher than it would have been in the absence of the ratios.

Insofar that sectoral lending ratios did increase lending to favoured sectors, the ratios would have undermined economic efficiency by encouraging over-investment in the favoured industries at the expense of under-investment in other higher earning sectors. In the absence of clearly identified market failures that caused private sector investment decisions to be sub-optimal from a national viewpoint, government interference simply resulted in wasted investment resources and a loss of potential national income.

Ratio controls, apart from the sectoral lending ratios, also ostensibly had the further objective of enhancing financial institutions' prudential soundness. The controls were supposed to reduce the risk of financial failure by ensuring that a significant proportion of financial institutions' assets was invested in government securities which, by their nature, are not subject to default risk. However, ratios tended to have the opposite effect. Prudential soundness was undermined by ratios mainly because government securities tended to be illiquid (due to their below-market yields and relatively long-term maturities) and could not, therefore, actually be used to obtain cash in times of emergency. In addition, enforced holdings of low-yielding government stock seriously undermined the capital positions of some financial intermediaries, especially the trustee banks. Sectoral lending ratios may also have undermined the prudential soundness of the system by forcing the affected intermediaries to be excessively exposed in their lending to particular sectors, especially the agricultural sector. Finally, ratios also reduced the profitability of the major categories of financial institutions, thereby encouraging more risky lending behaviour and promoting the development of fringe financial institutions not subject to the controls.

Ratio controls also had the unintended consequence of further discouraging private savings. The effective tax on institutions forced by the controls to lend at below market rates meant that ratio controls were yet another means by which governments discouraged private sector savings in the form of investment in financial assets.

In view of the failure of ratios as an instrument of monetary control, their costs in terms of economic efficiency and their adverse effects on the prudential soundness of the financial system, ratio controls were abolished in February 1985. The only cost to the Government of abolition was the loss of a source of cheap government funding. However, an implicit tax of this sort was not regarded as an efficient or equitable means of financing government activities. This attitude to ratios was reflected in the new Government's willingness to pay market-determined interest rates on its debt issues, which effectively rendered most ratio controls redundant from July 1984.

Like ratio controls, the credit growth guideline in place from 1982 to 1984 was not regarded as an effective tool of monetary management. This guideline, which permitted financial intermediaries to increase their lending by 1 percent per month (seasonally adjusted), generally contained no effective means of penalising non-compliance; accordingly, no individual institution had an incentive to adhere to the guideline.[7] As with ratios, the lending guideline could possibly have been designed to have a monetary policy impact, but at the expense of having severe efficiency costs within the finance sector. An effective credit growth guideline would have ossified existing market shares, preventing the more efficient financial intermediaries from taking business away from the less efficient. Moreover, had the guideline been used to tighten monetary policy effectively, higher interest rates would still have been called for to ration the scarcer supply of credit. When monetary authorities are able to gain control over the supply of liquidity and short-term interest rates by other means, then the use of a lending guideline as a tool of monetary management offers no benefits and many costs. Due to its efficiency costs and ineffectiveness, the lending guideline was scrapped in August 1984.

The New Monetary Management Framework

The scrapping of ratio controls and the lending growth guideline was part of a move towards a more efficient framework for monetary management. This new approach to monetary policy relies on influencing the excess demand for liquidity in the financial system and hence, in the first instance, short-term interest rates. All financial intermediaries' funding costs are liable to be affected by sustained pressure on short-term interest rates. Funding costs are, in turn, likely to affect the interest rates at which loans can be made and hence the ability of institutions to expand credit. This approach to monetary control is likely to be both effective, because it cannot be undermined by disintermediation, and efficient, because incentive effects are neutral; there is nothing within the monetary policy framework that gives an unfair advantage to a particular group of financial intermediaries.

The Reserve Bank's ability to influence the excess demand for liquidity stems from the Bank's position as monopoly supplier of settlement assets in New Zealand. The Reserve Bank, as the Government's banker, specifies that all payments to government be settled in "settlement cash", and this requirement underpins the banks' demand for cash deposits at the Reserve Bank. By influencing the supply relative to the demand for these assets, the Bank is able to influence short-term interest rates and, ultimately, money and credit growth. In addition to the banks' settlement cash deposits at the Reserve Bank, the operational reserves base definition, known as primary liquidity (PL), includes securities that can be discounted for settlement cash on demand at the Reserve Bank.[8]

The operation of monetary policy in the new institutional environment has involved targeting zero trend growth from year to year in the supply of PL and making discretionary adjustments to the various monetary policy instruments to try and ensure a consistent degree of downward pressure on nominal demand and inflation is applied. Zero trend growth in PL has been targeted through a policy of fully funding net public sector injections to primary liquidity through sales of medium- and long-term public debt. Following the exchange rate float in March 1985, public sector injections became the only possible source of growth in PL and, consequently, the full-funding policy was able to guarantee a stable trend level of PL from one year to the next. Open market operations and short-term Treasury bill sales are also conducted, with the aim of smoothing short-term variations in liquidity conditions. The uneven flow of government expenditure and taxation revenues through the year generated wide seasonal variations in the demand for PL, as defined to December 1988. Consequently, to avoid unnecessary short-term interest rate pressures, the within-year liquidity management operations deliberately allowed significant seasonal movements in the supply of PL. Since the change of PL definition to include Reserve Banks bills from December 1988, however, the highly seasonal influence of Treasury bills has been removed, leaving a stable precautionary demand for discountable Reserve Bank bills.

Over the 1985-88 period, it became clear that a stable quantitative relationship between PL and nominal GDP or inflation would be unlikely to emerge during a time of rapid structural change and disinflationary pressure. For this reason, the policy of zero trend growth in PL was supplemented by discretionary adjustments to the base level of PL and other monetary policy instruments. A passive medium-term approach to monetary policy, with unchanged instrument settings, would no doubt ultimately achieve the objective of a stable general level of prices; however, the transition path could potentially turn out to be either so lax or so restrictive as to undermine the policy's overall credibility. The main supplementary policy instruments available for discretionary adjustment are the discount margin,[9] the daily target for bankers' cash at the Reserve Bank and the average level of PL targeted over the month ahead. If it is desired to tighten monetary conditions using these instruments, the discount margin can be raised and/or the daily cash target can be reduced and/or the average level of PL for the month ahead can be lowered. An increase in the discount margin raises the demand for both PL and settlement cash whilst a reduction in the daily cash target or average monthly level of PL reduces the supplies of daily cash balances and PL. Any combination of these has the effect of reducing the excess supply of liquidity in the banking system, thus putting upward pressure on short-term interest rates. Open market operations are used to give effect to any changes in the daily cash and monthly average PL targets.

The need for a discretionary monetary policy has necessitated monitoring of a number of monetary indicators so that judgements can be made about whether or not monetary conditions are consistently firm. The main indicators monitored are: movements in the level and shape of the interest rate yield curve (an inverted structure is indicative of tight liquidity conditions); movements in nominal and real exchange rates; and growth in the money and credit aggregates. Movements in these indicators are assessed against a background of other relevant economic information in order to determine the extent to which movements in the monetary indicators reflect factors other than changes in underlying liquidity conditions.

Structural Reforms

Financial reform has also been aimed at improving efficiency within the financial sector. The general principles by which government interventions and regulations in this sector have been judged are competitive neutrality and contestability. The regulatory framework was reviewed to ensure that the treatment of all institutions and activities was more uniform and that, as far as possible, all activities were contestable. With interest rate controls, ratios and various other non-neutralities (such as the "30-day rule") already having been revoked, the major reforms called for by this review process were liberalisation of access to bank registration; removal of the special restrictions and benefits conferred on trustee savings banks; abolition of the controls on building societies; overhaul of prudential supervision arrangements; and reform of commercial legislation, including the Trustee Act 1956 and the Companies Act 1955.

(a) Liberalisation of Bank Registration

During the extensive review of the financial sector regulatory structure in 1984/85, it became clear that substantial changes would be required in the legislation governing the various categories of financial institutions. In the case of the trading banks, the relevant legislation (the Reserve Bank Act 1964) did not strictly preclude additions to the existing four banking licences, although a separate Act of Parliament was required in each case. Despite the absence of a prohibition on issuing further licences, it was not realistically possible for non-bank financial institutions to gain banking licences. Although such institutions were not thereby prevented from undertaking most of the activities performed by banks – the provision of banking services remained largely contestable[10] – bank-status continued to be coveted by many non-bank institutions, mainly because banks were widely regarded by the New Zealand public and the international financial community as being more secure and reputable.

In order to give all financial intermediaries so inclined the opportunity to obtain registration as banks, the Reserve Bank Amendment Act 1986 was passed, giving the Bank the power to register an unlimited number of banks, provided that certain conditions were met. These conditions have been interpreted by the Bank to include a commitment by the applicant to maintain an adequate ratio of capital to total assets and to ensure that capital also remains above a specified dollar value, to have business in the nature of banking, and to have demonstrable banking expertise. By December 1988, twelve new banks had been registered since the Reserve Bank Amendment Act 1986 had come into effect in April 1987. These registrations brought the total number of registered banks in New Zealand to sixteen.[11]

(b) Trustee Bank Reform

New Zealand has a network of community-owned banks around the country called trustee savings banks (TSBs). These banks have historically had their deposits government guaranteed and, in return, have not had the freedom of activity enjoyed by other financial institutions. In particular, trustee banks have not in the past been able to offer accounts to corporate clients, to offer foreign exchange services, to raise large-scale wholesale deposits or to acquire shares.

Regulatory changes (through Orders in Council) over the past few years have formalised TBSs' ownership arrangements, so as to strengthen the principal/agent relationships underlying day-to-day management, and have allowed TSBs to gain corporate clients and to offer limited foreign exchange services. The Trustee Bank Restructuring Bill, passed in May 1988, required all TSBs to become companies by 1 January 1989. As a consequence, all remaining restrictions on the operations of TSBs have now disappeared. Company status and an absence of special operational restrictions should help to facilitate the raising of external capital, thereby enabling TSBs to strengthen their position in respect of capitalisation. It is recognised, however, that this rise in capitalisation will take time and, accordingly, TSBs are to retain their government guarantee, as a transitional measure, for up to two years from the date of conversion to company status.

(c) Building Society Reform

Building societies also operated under their own Act and faced a range of restrictions on their investment and borrowing activities. So as to place building societies within the same regulatory framework as banks and other financial intermediaries, the Building Societies Act was amended in December 1987. Special restrictions on societies' investment and borrowing activities were abolished and, like registered banks, trustee savings banks and Postbank, they were exempted from the trust deed requirements of the Securities Act (1978). Building Societies were also given the option to move from operating under the Building Societies Act (1965) to registering under the Companies Act 1955. One of the major building societies has taken this step and has become a registered bank.

(d) Prudential Supervision

The process of reviewing the financial sector's regulatory framework included a review of the Reserve Bank's prudential oversight function. In light of the increasing breadth and complexity of the financial sector and the wish to maintain neutrality and transparency in policy interventions, it was apparent that prudential arrangements required for this role should be formalised. An ongoing prudential role for the Bank was considered necessary because of the possibilities that exist for the failure of one major financial intermediary to spread to the other intermediaries, potentially threatening the stability of the financial system. Bank failure can spread from one bank to others either directly, through the loss of claims on the failing bank, or indirectly, through a general loss of confidence in the soundness of the financial system. The potential for bank failures to cause serious economic effects in turn provided an economic rationale for establishing a formalised system of prudential supervison.

Prudential supervision has entailed monitoring data on major financial intermediaries' assets and liabilities so that the Reserve Bank can be kept informed about the risks to which individual institutions are exposing themselves. When exposures or other risk measures differ significantly from industry norms, the management of the institution concerned can be asked to explain to the Bank the reasons for those differences. If information provided to the Bank suggests that an institution could be expected to have system-wide implications, the Bank can first issue directives to that institution and, second, with the further approval of the Government, appoint a statutory manager to facilitate the institution's orderly exit.

The prudential supervisory arrangements set in place in New Zealand are different from those in many other countries in that deposits at financial institutions are not guaranteed. The decision not to guarantee bank deposits has been based on the Government's desire to avoid moral hazards and consequent financial sector efficiency costs. Rather than the protection of depositers, the aim of prudential supervision is to protect the financial system from unwarranted bank-runs and the potential flow-on effects of contagion.

(e) Reform of Commercial Legislation

A wide-ranging review of commercial legislation is presently underway and is likely to result in changes to the Companies Act 1955 when the review is complete. Some of the issues covered by this review include takeovers, disclosure requirements, insider trading, insolvency, directors' responsibilities, nominees' shareholdings and trust deeds.

Already this review has dealt with the Trustee Act 1956 and has resulted in extensive changes being made to that Act. The changes implemented in the Trustee Amendment Act 1988 do away with the "legal list" of approved trustee investments and instead give trustees the freedom to invest funds as they see fit, provided that the chosen investments are what a "prudent person" would have considered appropriate in the circumstances.

The Consequences of Reforms During 1984-1988

The reforms discussed in the previous section have all been aimed at improving the efficiency of resource allocation in New Zealand. Specifically, reforms have been targeted at removing distortions from the financial system that discouraged savings, encouraged a misallocation of investment resources and/or inhibited the development of an efficient financial sector. The savings, investment and financial intermediation consequences of these reforms are discussed in this section. Particular attention is also given to the respective performances of monetary policy and the float of the exchange rate in relation to their stated objectives.

It should be noted at the outset that it is not feasible at this stage to produce econometric evidence on the consequences of reforms. As yet, there is relatively little data available for the post-deregulation period. Without such an analysis, it is very difficult to separate out the individual effects of the various reforms and other external events. Furthermore, many of the effects of economic liberalisation will not become apparent for some years yet. For these reasons, our discussion of the consequences of specific reforms must be largely heuristic.

The Level and Uses of Saving

In the previous section of this chapter, part of the reason for instituting reforms was that they would reduce both artificial disincentives to save and artificial incentives to invest. Removal of these price distortions was expected to increase domestic savings relative to domestic investment and hence, *ceteris paribus*, to improve the current account of the balance of payments. By examining movements in the current account deficit in relation to national income, it is possible to determine whether or not the domestic supply of savings has improved in relation to investment demand. Table 2 shows that the balance of payments current account deficit as a percentage of national income has improved following an initial deterioration in 1984/85. Admittedly, part of the improvement since 1984/85 can be attributed to valuation effects resulting from the reversal of the 1984 devaluation in the real exchange rate. Nevertheless, even allowing for this factor, the current account deficits since 1986/87 have been lower than at any time since 1981/82 and are certainly much lower than the average deficits recorded over the decade to 1984.

Table 2 Net Savings by Sector (% of National Income)

Years Ended March	Net[1] Private Savings	Net[2] Government Savings	Current[3] Account Balance
1982	-0.6	-4.9	-5.5
1983	-0.7	-5.5	-6.2
1984	2.1	-6.9	-4.8
1985	-2.4	-6.3	-8.7
1986	-3.7	-3.1	-6.8
1987	-0.9	-3.5	-4.4
1988	-1.4	-2.2	-3.9
1989 (est)	0.5	-1.6	-2.1

Notes:

[1] Private savings less gross private investment. Obtained by taking Net Government Savings from the Current Account Balance.

[2] GFS Financial Balance.

[3] SNA definition.

A closer examination of the components of net national savings, however, tends to contradict the view that higher interest rates have been responsible for this change. As shown in Table 2, private sector savings, net of private investment expenditure, have been lower on average since 1983/84 than in the three years ended March 1984.

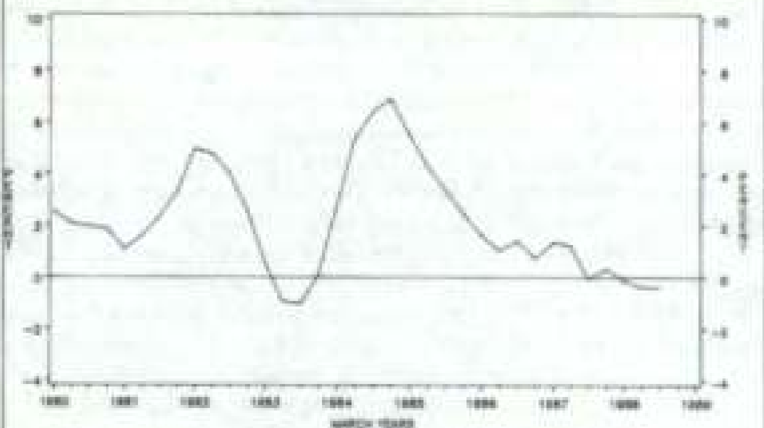
Net private sector savings were consistently low between 1984/85 and 1985/86 but recovered sharply in 1988/89. Most of the improvement in the current account balances since the early 1980s has been due to a reduction in government's claim on savings, with significant reductions in the fiscal deficit having been achieved since 1984/85. Only more recently in 1988/89 has the improvement in the current account balance been attributable to a recovery in net private sector savings.

The failure of net private savings to rise significantly during the three years following the increase in real interest rates in 1984/85 may have resulted from a number of other opposing influences, and does not necessarily imply very low interest elasticities of savings and investment. First, the public may have been super-rational, incorporating government-saving decisions into their own decision-making. Hence, rational economic agents could have reduced their net savings to the extent that the Government increased its net saving, thereby maintaining their preferred time-path for national consumption. Second, and perhaps more plausibly, government measures to increase government saving have tended to reduce private sector disposable incomes and hence the private sector's ability to save. Third, a high level of overseas confidence in New Zealand has meant that foreign savings were relatively cheaply available for domestic expenditure. Fourth, structural change initiated by deregulation has called for temporarily high levels of investment in the expanding industries. For instance, the increased demand for the services of financial intermediaries and business advisors is likely to have increased demand for office space in Auckland and Wellington, encouraging commercial building construction in these centres; indeed, commercial building investment grew from a high base at the phenomenal real rate of 20 percent per annum over the three years to March 1988. Fifth, greater reliance on interest rates to allocate loanable funds has given many members of the public increased access to credit, enabling them to move to higher gearing ratios. Sixth, the sharemarket boom increased the private sector's perceived wealth, and hence permanent income, thus encouraging individuals to increase consumption and investment expenditure in relation to current income. The sharp rise in net private savings in 1988/89 tends to suggest that the sharemarket boom was a particularly important factor in depressing net private savings over 1984–87.

Deregulation was also expected to redirect resources to the highest earning sectors, resulting in an increase in the average rate of return on investment. More specifically, as a wider range of domestic and overseas investments became eligible to compete for the available domestic savings, those activities previously earning a low return might have been expected to phase out and new higher return (higher risk) growth sectors to emerge. Over a sustained period, by shifting resources away from poorly performing sectors towards new growth areas in the economy, this process may be expected to generate an increase in the overall rate of return on capital and hence an increase in the productive potential of the national economy.

In terms of assessing any such improvements in long-term productive potential, it will clearly not be possible to make a fair assessment until sustained reductions in inflation have been achieved and real interest rates have declined to more normal levels. However, it is certainly the case that the growth in aggregate activity has tended to exceed forecasts over the 1985-88 period, with both demand and output exhibiting considerable resilience in the face of the Government's restrictive financial policies. The high GDP growth of 1984/85 was essentially due to the lagged effects of earlier expansionary demand policies. However, as the Labour Government's contradictory macro policies took effect from 1985 onwards, output growth held up at around 2 percent per annum through the first half of 1987 (see Figure 1).

Figure 1 : Real GDP Growth[1]
1980 – 1988



[1] Four Quarter Running Totals APC.

The contributions to real growth over the 1984-88 period can be assessed from both the demand and supply sides (see Table 3). The breakdown of expenditure components shows that the main contributions to demand growth came from private consumption, "other" private investment (dominated by commercial construction over this period) and exports. The output components show much of the growth of the supply side coming through agriculture, construction and private services.

Table 3 Contributions To Growth: 1984/85 - 1987/88[1]

	Annual Average % Growth	Annual Average % Point Contribution to GDP Growth
Expenditure Components		
Private Consumption	1.9	1.2
Government Consumption	1.3	0.2
Private Investment - Residential	0.1	0.0
Private Investment - Other	4.9	0.6
Government Investment	-3.7	-0.3
Stocks	N/A	0.0
Total Domestic Expenditure	1.7	1.7
Exports of Goods and Services	4.7	1.4
Imports of Goods and Services	6.2	-2.0
Expenditure on GDP[2]	1.1	1.1
Output Components		
Primary	8.0	0.7
Manufacturing	0.8	0.2
Construction	4.9	0.3
Private Services	2.1	1.0
Government Services	-0.5	-0.1
GDP	2.1	2.1

Notes:

[1] New Zealand Department of Statistics: Reserve Bank estimates for 1987/88.

[2] Does not match output measure of GDP due to statistical discrepancy.

The growth in private consumption and commercial construction has been associated with the effects of deregulation and, in particular, the rapid growth in equity and property values that occurred through 1985 and 1986. Household consumption remained firm despite a shift in income distribution away from households towards the corporate sector. The underlying decline in household savings ratios resulted both from the increase in stock market and property wealth, and from the upward regearing of household portfolios that followed the removal of credit and interest rate controls. Consumption was given a further boost in 1986 as expenditures were brought forward in anticipation of the 10 percent Goods and Services Tax (GST), introduced in October. Commercial building activity responded rapidly to the upturn in property prices, which, in turn, reflected strong demand for office and hotel accommodation in the financial, business services and tourism sectors.

The significant contribution from exports to the growth in total expenditure on GDP was associated primarily with the high average growth in agricultural production. In part, this reflected a temporary increase in slaughter rates that occurred as sheep herd sizes were run down following the removal of government subsidies on traditional pastoral export commodities. (Added to this is the tendency for growth in agricultural "value added" to be falsely accentuated at the initial stages of a decline due to the inclusion of capital inputs, such as fertiliser, as current farm expenses.) However, the contributions from both exports and agriculture also reflected strong growth in non-traditional primary sectors such as fishing, specialised foodstuffs, and horticultural products – most notably kiwifruit.

While it is too early to draw conclusions about the overall impact of deregulation on longer-term national productivity performance, there is certainly evidence of major shifts in the direction of financial flows and of rationalisation in productive enterprises. The latter has been evident in a high level of merger and acquisition activity, and in the emergence of new forms of intermediation between equity investors and banks on the one hand, and individual enterprises on the other. An increasing sophistication in investment management has brought a greater flexibility to the use of funds and a broader perspective to the analysis and selection of investment opportunities. In turn, these developments have imposed a greater discipline on individual enterprises, ensuring that they work to achieve the maximum return on allocated investment funds. In a similar vein, large industrial companies have tended to broaden their horizons so that expertise in a particular industry can be applied to maximise returns in a global market context rather than being limited by the parameters of the small New Zealand marketplace.

Further evidence of the increased flexibility of the intermediation process can be seen in the high rate of growth that has occurred in business services – financial services in particular; the strong demands for expert advice in the areas of financing, management systems, information technology, marketing and personnel are all symptomatic of the process of change itself, and of a higher performance being demanded across a wide range of economic activities.

While deregulation has contributed to a redistribution of savings through the economy by imposing a discipline on the effective use of savings, this mechanism is not sufficient in itself to deliver the intended growth in productive potential. It is also necessary to ensure that rates of return signalled by market prices are compatible with social and economic rates of return.

Actual measured market rates of return on capital investment are, of course, distorted by a large number of rigidities and government interventions that may be alleviated through further policy reforms, some of which are discussed in Section 4 of this chapter. However, probably the most important relative price to consider is the real exchange rate, which affects the price of traded versus non-traded goods. This relative price is discussed below in the context of the floating New Zealand dollar exchange rate.

Price Signalling and the Floating Exchange Rate

The float of the New Zealand dollar in March 1985 was adopted as an integral part of the financial reform programme. Combined with the earlier freeing up of domestic financial markets and the removal of restrictions on international capital flows, the float was intended to achieve two main objectives:[12]

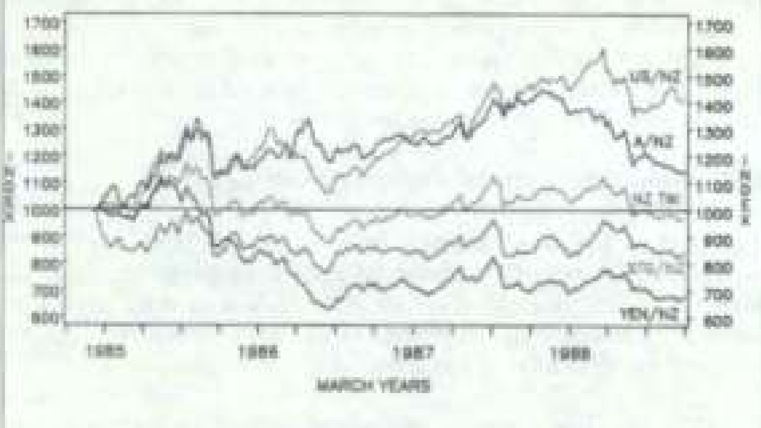
1) To facilitate adjustment in domestic consumption and production patterns in response to shifts in New Zealand's internal and external environment.
2) To give control over the reserves base of the financial system and hence allow an independent discretionary monetary policy.

A further subsidiary objective was to avoid a repeat of the situation in June/July 1984 where significant amounts of taxpayers' funds were put at risk – and lost – in the defence of a managed exchange rate.

With respect to the first objective, it was well recognised that real exchange rate adjustments could be achieved under a fixed nominal exchange rate and that the Government could be prevented from sterilising adjustment pressures provided that exchange controls were lifted from private capital flows. However, it was considered that this form of adjustment mechanism could generate irregular and possibly severe pressures on interest rates and hence aggregate output and employment, particularly if nominal wages remained inflexible downwards. This alternative would also have prevented the implementation of an effective disinflationary monetary policy, which was seen as an essential component of the overall reform programme.

The experience to date with the floating exchange rate is summarised in Figure 2 and in Table 4. Between March 1985 and December 1988, the trade-weighted index (TWI) of the New Zealand dollar has moved in the range of 53.6 to 73.4, about an average of 63.2. While no long-term trend is discernible in the TWI, individual bilateral rates have moved substantially as a result of large shifts among the major currencies. Over the same period to December 1988, the New Zealand dollar appreciated by 16 and 41 percent against the Australian and United States dollars respectively, while depreciating by 32 and

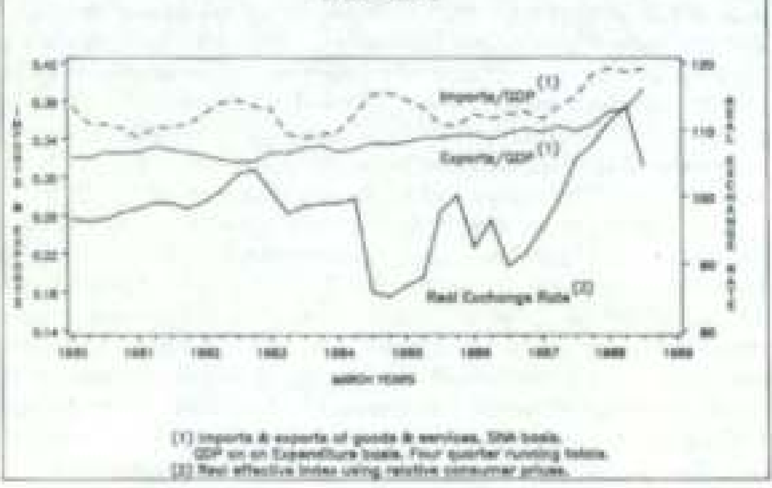
Figure 2 : Relative Exchange Rate Movements (1)
1985 – 1988



(1) Weekly Averages

25 percent against the yen and the Deutschmark respectively. Once allowance is made for New Zealand's unfavourable inflation differential, it is clear that there was a major loss of competitiveness vis-a-vis Australia and the United States during the three years to early 1988. However, declines in the nominal exchange rate and a lower domestic rate of inflation brought about a significant improvement in competitiveness in 1988, particularly against Australia. Movements in the real effective exchange rate (Figure 3 and Table 4) indicate

Figure 3 : Real Exchange Rate and Trade
1980 – 1988



(1) Imports & exports of goods & services, SNA basis.
GDP on an Expenditure basis. Four quarter running totals.
(2) Real effective index using relative consumer prices.

that overall competitiveness worsened by around 24 percent from the time of the float to December 1988, leaving the real exchange rate about 6 percent higher than before the July 1984 devaluation.

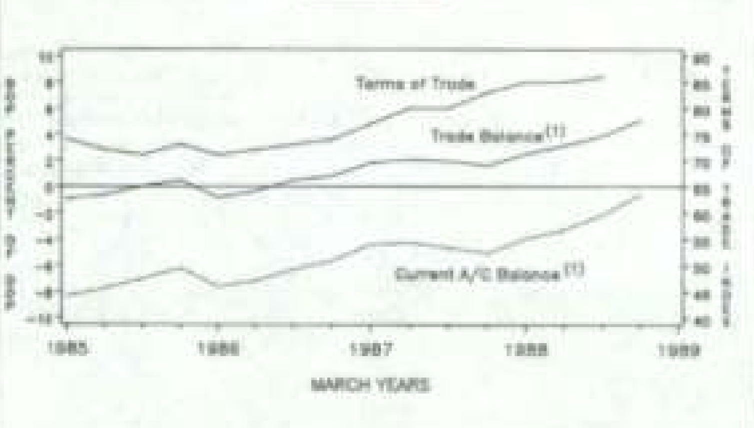
Table 4 New Zealand Dollar Exchange Rate Movements

	Percentage changes to 30 December 1988	
	Pre-Float	Pre-Devaluation
USD	40.6	1.4
STG	-15.4	-26.0
YEN	-31.9	-47.5
$A	16.4	2.0
DM	-24.9	-36.5
TWI	-2.3	-21.9
Real Effective	24.1(e)	6.0(e)

There was a widely held view over much of the 1985 to early 1988 period that the recent high levels of the real exchange rate would not be sustainable over the longer term. Supporters of the counterview have pointed to the major structural changes that have occurred in the New Zealand economy since 1984, and the increased earnings that may eventually flow from these changes. They have also questioned whether recent trends in the balance of payments supported the case of an overvalued real exchange rate. Total exports of goods and services have continued to increase as a proportion of GDP (Figure 3), and the current account deficit as a proportion of GDP was more than halved between 1984/85 and 1986/87, from 8.3 to 3.7 percent (Figure 4). Since then, the current account deficit has fallen further and is forecast (by the Reserve Bank) to be around 2 percent of GDP in 1988/89.

Nevertheless, there are good reasons for claiming that 1985-88 levels of the real exchange rate were not sustainable over the longer term. First, from the point of view of both foreign and domestic capital market participants, the continuing interest rate differential on short-term maturities had been consistent with an ongoing perceived risk of exchange rate depreciation. Second, from the point of view of the current account deficit, a gap of about 2 percent of GDP is still expected between national savings and investment in 1988/89, despite a very low average level of domestic demand and a boom in export commodity prices. As such, in the absence of a downward adjustment in the real exchange rate, the underlying deficit position may eventually have been expected to cause a further deterioration in New Zealand's overseas debt to GDP ratio. Of course, the 12 percent reduction in the exchange rate (trade weighted index)

Figure 4 : Terms of Trade and Balance of Payments 1985 – 1988



(1) BOP basis. Four quarter running totals.

over the latter part of 1988 has substantially weakened this argument in the context of more recent real exchange rate levels.[13]

Apart from the casual empirical evidence, there are theoretical arguments which also suggest that the exchange rate may have been above its long-run equilibrium during 1985-88. These arguments are based on the ability of financial markets to adjust more quickly to shocks than goods and labour markets. As will be discussed more fully in Section 4, the dominant initial response of financial flows to the decontrol of international capital flows, combined with the Government's disinflationary monetary policy, is likely to involve a net capital inflow which pushes the real exchange rate above its equilibrium position. Only after real goods and labour markets have been effectively subjected to deregulation and the effects of the disinflation policy will current account flows fully reflect the intended new trading environment, and hence bring the real exchange rate back towards its long-run equilibrium.

If differential speeds of adjustment in asset and goods markets have indeed given rise to exchange rate overshooting, then the distorting effects of this phenomenon may be reduced by pushing ahead more rapidly with measures designed to increase flexibility in markets for goods, services and factors of production. In particular, policies aimed at removing protective mechanisms in the labour market, the public sector and the more insulated segments of domestic industry can help to spread the burden of adjustment more evenly, and hence relieve some of the pressure on the exposed traded goods sector.

Possible alternative policy prescriptions could include the introduction of controls on inward capital movements and/or exchange market intervention. However, it is argued in Section 4 below that the first of these two alternatives could raise severe credibility problems for the overall reform programme as well as presenting significant implementation difficulties. With respect to the second alternative of exchange rate intervention, it is widely accepted[14] that a sustained reduction in the exchange rate may only be achieved if the intervention is allowed to generate a monetary expansion. Thus, if the New Zealand dollar exchange rate was to be maintained at a lower level, it would be necessary to ease off the Government's firm monetary policy stance. Such an easing, however, would generate inflationary pressures which would eventually offset any short-term competitive gain.

Apart from the perceived high level of the New Zealand dollar exchange rate, many commentators have expressed concern over the volatility of the exchange rate since the float in March 1985. This volatility is said to result in reduced certainty of marketing and production planning decisions and hence a lower level of participation in both exporting and importing. At the time of the float, it was recognised that exchange rate volatility would be present to some degree, and that this would represent a cost to producers and consumers of traded goods. However, it was also considered that the potential costs of short-term volatility under a float were likely to be overshadowed by the potential losses from "getting it wrong" under an administered regime. Furthermore, it was recognised that volatility was not actually avoided under a managed exchange rate; it was just dealt with in different ways.

The degree of volatility experienced in the New Zealand dollar since March 1985 is compared against volatility measures for the major currencies and the Australian dollar in Table 5. These figures indicate that, in terms of both daily and monthly changes, the New Zealand dollar has been somewhat more volatile than the major currencies. With respect to the impact of exchange rate volatility on trade volumes, the available evidence has generally failed to find significant effects.[15] Also, in the exceptional cases, any significant effects are found to be relatively small.[16] In the case of New Zealand, a significant influence of exchange rate volatility on bilateral trade with Australia has been detected,[17] but this effect is again small, and no other bilateral flows were found to be affected.

Table 5 Exchange Rate Volatility*
(April 1985-December 1988)

Currency	Daily Movements	Monthly Average Movements
NZ	1.02	3.89
YEN	0.76	3.20

Continued Table 5

Table 5 Exchange Rate Volatility* (April 1985-December 1988)		
Currency	**Daily Movements**	**Monthly Average Movements**
AUS	0.82	2.79
STG	0.84	2.74
DM	0.83	2.89

Note:

* Standard deviations of first differences in logs of daily and monthly average exchange rates, multiplied by 100. Exchange rate measured against US dollar.

Even in the absence of significant effects on trade volumes, there may be an argument for some smoothing by the monetary authorities – using sterilised intervention – in order to reduce the private costs of transacting in foreign exchange and of covering short-term exchange risks. However, to be sure that such a policy was effective in reducing the overall cost of managing exchange rate volatility, it would be necessary for the intervention agency to be profitable – or at least not make losses. Quite apart from the question of whether the Reserve Bank can consistently outplay the market, there are other potential costs attached to an intervention strategy which, to date, have further deterred the Government from attempting smoothing operations under the present regime. First, Reserve Bank participation in the market would hinder the further development of the foreign exchange market and its associated "insurance" markets,[18] thus reducing its potential for becoming more self-stabilising. Second, and more importantly, the international experience with exchange market intervention in recent years has shown quite clearly the difficulty of limiting an intervention policy to a short-term smoothing role. Once intervention starts, it may quickly evolve into a longer-term "support" operation involving large potential intervention losses. Because of this possibility, any attempt at sterilised intervention would be likely to damage the credibility of the Government's overall exchange rate and monetary policies.

In summary, the main costs associated with the floating of the New Zealand dollar have probably arisen from the sustained strength of the exchange rate during the disinflation/liberalisation phase, rather than from the short-term voltaility that has been experienced since March 1985. As concluded in a review of the major floating currencies,[19] the relatively minor nature of volatility effects implies that the intervention debate should relate primarily to the trade-offs between internal and external objectives rather than the potential for an effective smoothing operation. In particular, in the current New Zealand situation, any case for intervention to lower the real value of the New Zealand dollar must be assessed against the cost of compromising the Government's present firm monetary policy.

Monetary Control and Disinflation

The principal stated objective of monetary policy has, for many years, been the achievement of low, single-figure inflation. This objective has, however, been frustrated by conflicting demands placed upon the monetary policy mechanism. In particular, up until 1985, various attempts to directly control money and credit growth were undermined by simultaneous attempts to fix the exchange rate and, from time to time, interest rates. In this situation, with restrictions on interest rates and with less-than-full insulation from international capital movements, the monetary authorities found they were unable to achieve effective control over the supply of money and credit.

Under the monetary control mechanism operating from the time of the float in March 1985, the authorities have not attempted to achieve *direct* control over the measured money and credit aggregates. However, with interest rates and the exchange rate now freely market determined, the Reserve Bank has for the first time been able to control directly the reserves base of the financial system. Furthermore, the process of financial deepening that accompanied deregulation and the floating of the exchange rate has meant that control of the reserves base can exert a more pervasive influence over economic activity than previously. While continuing to operate through the traditional quantity and price rationing effects on credit expansion, policy also directly affects domestic demand through the general level of interest rates and net external demand through the exchange rate. Thus, the scope for effective monetary control, and hence the attainment of price stability, has been clearly enhanced in the new deregulated financial environment.

Of course, it does not follow from this outcome that the actual implementation of monetary policy has been optimal or even effective in achieving its aims since 1985. The intention of monetary policy has been to apply consistently firm pressure to monetary conditions, with the aim of reducing the underlying rate of monetary expansion and hence, eventually, the rate of price inflation. The results to date in terms of both the rate of inflation (Figure 5) and monetary indicators (Figures 6 and 7) have at times been difficult to interpret and have only shown substantial improvement since mid-1987. With respect to the main monetary indicators - in particular, money and credit growth, interest rates and the exchange rate - the relationships between the instruments of policy and the indicators themselves and structural

Figure 5 : Consumer Price Index (1984–88)
Annual & Quarterly Percentage Change

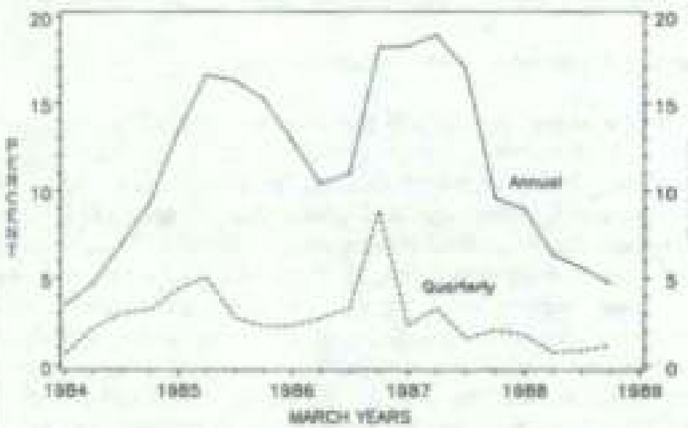
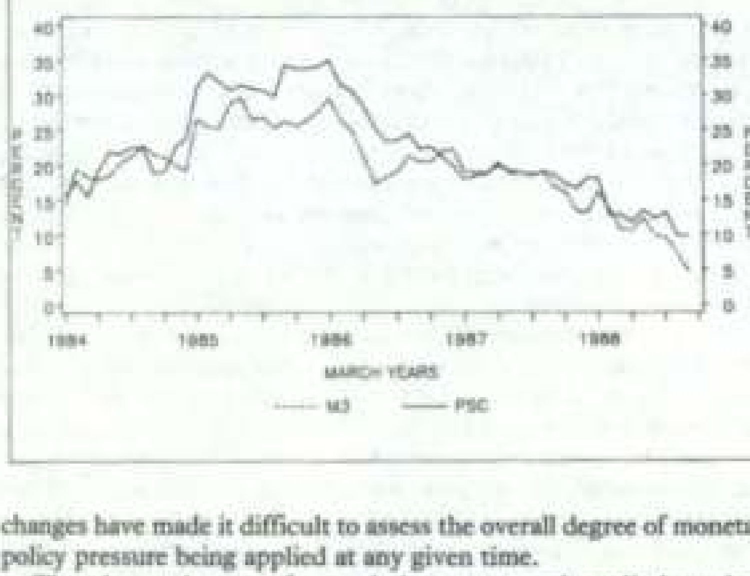


Figure 6 : Monetary Indicators (1984–88)
Money and Credit – Annual Percent Changes



changes have made it difficult to assess the overall degree of monetary policy pressure being applied at any given time.

The observed rates of growth in money and credit have been substantially affected by a number of factors which have tended to exaggerate the rates of growth in M3 and Private Sector Credit for example. A major influence has been the process of financial re-

intermediation which occurred as funds flowed back through the trading banks and other large institutions following the removal of quantitative and interest rate restrictions. Also contributing to the rapid rate of money growth over 1985/86 was the increased scope for households and corporations to increase their gearing in the wake of financial deregulation and the wealth effect on spending and borrowing arising from the boom in property and equity values. As a result of these factors, M3 and private sector credit growth reached annual rates of 29 and 34 percent respectively during 1985/86, before commencing on a downward trend from the June quarter 1986 onwards.

From a more general perspective, the changing structure of the economy and the high level of uncertainty regarding the ultimate effects of the various policy measures has considerably complicated the interpretation of monetary and economic indicators alike. This situation was no better demonstrated than in 1986 when economic confidence and perceptions of policy outcomes changed substantially through the year. During the first half of the year, a decline in interest rates was seen to be consistent with the fall in consumption and investment indicators and various favourable signs as to the future path of inflation and the fiscal deficit. As the year progressed, however, it became increasingly apparent that domestic demand and inflation expectations were holding up, both on the basis of increased property and equity values and in anticipation of the new 10 percent GST to be introduced in October 1986. The resulting incipient expansion of credit demand led to a tightening of monetary policy in September/October 1986 and an upturn in interest rates through the December and March quarters. The impact on interest rates through this period was compounded by seasonal liquidity pressures and an increased pessimism with regard to expected inflation and fiscal deficit outcomes. Thus, while the shifts in interest rates and the exchange rate through 1986/87 resulted partly from a changing degree of monetary policy pressure, they also reflected major shifts in expectations regarding the impact and ultimate success of the policy reforms. In this respect, with extraneous factors significantly affecting both the monetary aggregates and interest rates, it has not been possible to gauge the consistency of monetary policy pressure simply in terms of any one of the monetary indicators. If any one indicator, such as the level of interest rates or the exchange rate or money growth, had been targeted more rigidly, then the variations in underyling monetary conditions may well have been accentuated.

With respect to the path of consumer price inflation (Figure 5), three features are dominant: the continued rise in inflation through to June 1985; the resurgence of measured inflation in the December quarter 1986 corresponding to the introduction of GST; and the rapid decline in measured inflation since the September quarter 1987. The first of these features represents a response to the aftermath of the price and wage controls, which were removed progressively during 1984. Attempts to restore appropriate relativities to wages and prices, including government charges, and the effects of the 20 percent devaluation in July 1984, combined to push the annual rate of inflation to 16.6 percent by June 1985. Also, as noted earlier, firm control over monetary conditions was only achieved after the float in March 1985; prior to that, in the second half of 1984, the capital inflows associated with higher domestic interest rates had tended to undermine attempts to restrict money and credit expansions.

The second confounding influence on the downward path of consumer price inflation, the 10 percent GST in October 1986, was a major obstacle to the disinflation effort over 1986/87. The direct CPI effect of the GST was contained in that it was concentrated in just one quarter and, with income taxes being reduced concurrently, it did not spark a wage-price spiral. However, the GST did generate a disruptive resurgence in demand midway through 1986 and, as a result of the long-lasting effect on the measured annual inflation rate, it almost certainly added to inflationary expectations and hence the high nominal interest rates that continued into early 1988. These effects on demand and expectations contributed not only directly to the presence of inflation in 1986/87, but also indirectly by clouding the interpretation of monetary conditions and hence contributing to the unintended easing of monetary policy that occurred in 1986.

The decline in annual inflation since September 1987 has clearly been strongly influenced by the passage of the GST effect: the reduction in the annual inflation rate from 16.9 percent in September

1987 to 9.6 percent in December 1987 largely reflected this factor. However, the underlying inflation rate has also fallen markedly since late 1987, as indicated by the continued drop in the inflation rate to 4.7 percent for the year to December 1988. The disinflationary monetary policy of the past four years is now clearly yielding significant results.

While New Zealand's progress with lowering inflation has taken a number of years to show clear results, a comparison with the disinflation experiences of other industrial countries in the early 1980s suggests that this rate of progress is not unusual. Table 6 shows that adjustment periods of three to five years were typically required to reduce inflation below 5 percent, even in countries such as the United Kingdom and Switzerland where relatively severe adjustment strategies were pursued.

Table 6 Disinflation Experiences in Industrial Countries

	Tight Policy Applied	Peak Inflation (percent p.a.)	Period to Reduce Inflation Below 5%
Canada	Dec. 1978	12.9 (June 1981)	4¾ years
Japan	June 1979	8.6 (Sep. 1980)	2 years
Switzerland	June 1979	7.5 (Sep. 1981)	3¾ years
United Kingdom	June 1980	21.0 (June 1980)	2¾ years
United States	Oct. 1979	14.8 (Mar. 1980)	3 years
New Zealand	March 1985	16.6 (June 1985)	3¾ years

If New Zealand follows the early experience of many industrial countries, then a consolidation of low inflation through 1989 will help to build confidence in continued low inflation, thus reducing real interest rates and allowing the economy to take full advantage of the restructuring that has occurred over the past four years. The emerging economic recovery may, of course, put upward pressure on some prices through 1989/90. However, the continued depressing effects of the relatively weak equity and property markets, combined with some strong favourable productivity effects, should help to ensure a continuation of the overall downward trend in inflation.

Financial Sector Efficiency

The preceding sections on the level and use of saving and price signalling and the floating exchange rate discussed the consequence of deregulation in terms of the effectiveness of the financial sector in achieving an appropriate distribution of real and financial resources amongst alternative economic uses. A further objective of deregulation has been to improve the efficiency of the financial sector; to minimise the costs involved in financial intermediation between savers and investors and in the management of economic risk. As indicated in the introduction to this chapter, the removal of price and quantity restrictions from portfolio structures was also expected to make for a safer financial system by improving the ability of financial institutions to manage risk and hence make managers more accountable for their portfolio decisions.

The evidence of efficiency gains is largely circumstantial, but nevertheless persuasive. There has been a boom in the financial services industry since 1984, with a major reorganisation of ownership and management structures and rapid expansion in the array of available financial services and products. In large part, this growth has mirrored other factors apart from domestic financial deregulation. In particular, a rapid rate of innovation and growth in global financial markets, combined with the major changes occurring throughout the domestic economy, have caused an overall increase in demand for financial intermediation and risk management services. However, there seems little doubt that financial deregulation to date has compelled banks and other financial institutions to improve the quality, range and relative cost of services on offer.

The gains in efficiency accompanying this process would appear to arise from two main sources. First, there is the increase in competition and potential competition arising from the threat of new entrants, which puts pressure on institutions extracting abnormal profits from particular market segments. In the market for consumer finance, for example, traditionally high margins (in the order of 8 to 10 percent) were substantially reduced through 1985/86 as non-traditional suppliers of consumer credit entered this market. While it is also apparent that margins have fallen in other areas, for example, in stockbroking, there is insufficient statistical evidence to make any quantitative assessment of such gains. Clearer evidence of efficiency improvements may well emerge in due course as the lagged effects of deregulation measures begin to have a stronger effect on competition. The effect of new banking licenses, for example, has clearly yet to be fully felt on the marketing and pricing[20] of products in the banking industry. Furthermore, while trustee banks gained increased operating freedoms from December 1985, the legislation governing the structure and activities of both trustee banks and building societies has only recently been amended to allow these institutions to be fully competitive.

Second, there would appear to be potential for significant economies of scale to be achieved through product diversification in an unrestricted financial sector. Such economies arise from the tendency for financial products and services to be of a joint product nature, with human capital and information as the dominant factor inputs.[21] The difficulties involved in trading client-based information and intellectual property, together with the synergy that can be generated within teams of dealers, financial analysts, etc., means that overall industry costs can be minimised by building diversified and inter-related product ranges within individual institutions.

Certainly, there has been a tendency since 1984 for diversification of activities within individual financial institutions and for concentration of ownership through mergers and acquisitions. The degree to which this adaptation has occurred across the industry has depended on both the nature and extent of direct and indirect taxes imposed prior to 1984 and the speed with which restrictions were removed. In the case of the four major trading banks, the removal of interest rate controls allowed a rapid improvement in competitiveness and a significant increase in their share of deposit and credit markets. This reintermediation of funds from "fringe" institutions back to the major banking institutions was an important cause of the surge in measured money and credit aggregates that occurred through 1985/86 (Figure 6). In the face of competition from merchant banks and the imminent issue of new bank licences, the trading banks also moved to diversify substantially their range of products and services; in particular, to take advantage of the strong demand for specialised corporate financial services and to establish dominance in the expanding markets for foreign exchange, wholesale money market funds and government securities.

On the other hand, the building societies, and to a lesser extent the trustee banks, have been restricted in their ability to compete and diversify because of the burden of large pre-1985 government security holdings and because of the considerable length of time taken to fully remove legislative impediments from these groups of institutions. However, with the trustee banks and building societies respectively achieving a greater freedom of action and organisation in 1988 and 1989, it seems likely that they will also undergo a rationalisation process[22] and expand their range of products and services. In particular, with the removal of stamp duty in March 1988, these institutions are likely to figure largely in the development of new mortgage instruments and mechanisms for trading mortgage risks.

As diversification has caused many institutions to become direct participants in the expanding foreign exchange and securities markets, there has been a parallel growth in specialised "insurance" products (aimed at providing efficient means for managing risks), particularly foreign exchange and interest rate exposures. These include futures contracts: in the US dollar, the Barclays stock market index, wool prices and interest rates; forward interest rate and foreign exchange markets; and interest rate and foreign exchange options. Such products have grown out of a demand from private market participants for methods of avoiding risks that were previously either not present, covered by government or unavoidable as a result of the previous institutional and regulatory structure. To the extent that deregulation has caused market prices and interest rates to become more volatile, then the private cost of covering risks associated with such price movements has no doubt increased. However, to the extent that deregulation has simply shifted the distribution of risk among different markets and between the government and the private sector, then the present market-based system is likely to represent a more efficient mechanism for allocating and matching risks than was the case when exposures were unavoidable by many institutions and accepted arbitrarily by government on behalf of the taxpayer.

4. The Sequencing of Reforms

Within the overall context of the economic liberalisation strategy adopted in New Zealand in 1984, the freeing up of both the domestic financial sector and the linkages with external financial markets occurred relatively quickly compared with progress in other areas such as the removal of trade protection and the freeing up of the labour market. As pointed out in the above discussion on price-signalling and the floating exchange rate, this uneven progress in the liberalisation strategy, combined with the effects of the Government's disinflation policy, may have contributed to ongoing distortions in relative prices through 1984-88. In particular, as a result of the upward pressure that has been applied to the value of the New Zealand dollar, there is reason to suggest that traded goods became undervalued in real New Zealand dollar terms. Indeed, much of the criticism that has been levelled at the Labour Government's economic strategy over the past four years has been aimed not so much at the ultimate objectives of the strategy but at the sequencing of the reform process.[23]

In reviewing the arguments that have been put forward on the optimal sequencing of economic liberalisation measures, the first thing to recognise is that there are no general results that show how to achieve a welfare maximising transition to a "liberalised" economic structure. While there are good theoretical arguments to suggest that the simultaneous removal of all market distortions will be welfare improving, there is nothing general that can be said in "second best" situations, where a particular distortion is removed while others remain.

Nevertheless, there has developed a body of opinion that certain rules of thumb should be followed in order to minimise the disruptive consequences of a liberalisation programme. These guidelines, which have been developed by such economists as R. I. McKinnon,

A. O. Krueger, D. J. Mathieson, S. Edwards and J. A. Frenkel,[24] can be roughly summarised as follows:

- Macroeconomic policies should support the liberalisation programme. In particular, inflation and the fiscal deficit should be brought under control at an early stage in the reform process.

- Distortions in domestic goods, capital and labour markets should be removed as far as possible before links with the external economy are opened up.

- In liberalising links with the external economy, the capital account should only be freed up once substantial progress has been made in liberalising trade flows.

- In order to minimise the transition costs and to give the liberalisation programme a good chance of eventual success, it is crucially important to establish its credibility as a consistent package that will deliver long-term benefits for the overall economy.

Of most interest in the New Zealand situation is the third guideline and, in particular, the suggestion that international capital flows should not be liberalised until after the real economy has been allowed to respond to the freeing up of trade restrictions. Various lines of argument have been advanced in support of this prescription, most of which are based on the ability of asset markets to adjust more rapidly than goods markets. Frenkel argues that the likelihood of a rapid response to the freeing up of capital flows would give too sudden a shock to the economy; the trade account should therefore be freed up first so that the adjustment process may be made more evenly and more gradually. Frenkel also considers that "wrong" financial decisions resulting from a delay in exchange control removal will be less costly to reverse than "wrong" real investment decisions resulting from a delay in trade liberalisation. A somewhat different line of reasoning is followed by Edwards and Mathieson, who are primarily concerned with the overshooting of the exchange rate that has occurred during a number of liberalisation programmes, including those in the southern cone countries of South America in the mid- to late-1970s. The removal of restrictions on foreign borrowing, combined with the upward pressure on real interest rates that will accompany a firm monetary policy, is expected to generate a large capital inflow which, in turn, will cause a temporary appreciation in the real exchange rate above its long-run equilibrium level.[25] As the slower goods markets start to react to international arbitrage opportunities, the exchange rate begins to fall in response to a deterioration in the current account of the balance of payments. By this time, however, investment distortions may have occurred as a result of the temporary undervaluation of traded versus non-traded goods in local currency terms.

However, it is readily acknowledged by both Mathieson and Edwards, for example, that there are problems with the overshooting argument as a basis for the recommended policy prescription of delaying capital account liberalisation. Furthermore, other arguments have been put forward which suggest that the "recommended" sequencing of external liberalisation could, in certain cases, actually worsen the prospects for successful implementation of a full reform programme.

First, there is a case to suggest that large numbers of "wrong" investment decisions will not be made on the basis of a real exchange rate which is understood to be temporarily overvalued during the transition period. Edwards and A. C. Stockman,[28] for example, point out that if the "authorities" see a clear case of exchange rate overshooting, then this situation should also be apparent to private agents, who should take it into account in making investment decisions. The number of "wrong" investment decisions may also be reduced to the extent that the intended future path of trade liberalisations is clearly telegraphed to potential investors. While this argument must have some validity, it must also be recognised that investment (and disinvestment) decisions will, to some extent, be influenced by short-term profitability considerations, even though investors may expect relative price corrections to occur in the longer term.

Second, and of greater importance is the point that exchange rate overshooting following the removal of exchange controls is likely to occur to some degree whether capital controls are removed early or late in the liberalisation process. In other words, while an alternative sequencing of liberalisation measures may reduce the extent of overshooting, it is unclear whether the difference will be significant, and it is certainly not likely to avoid the problem. Financial portfolio structures must at some stage be brought into line during the liberalisation process, and this is likely to generate a temporary surge in capital inflows, irrespective of the progress that has been made in trade liberalisation. Furthermore, in a situation where political constraints prevent rapid progress in liberalising goods and factor markets, an attempt to follow the "recommended" policy sequence by delaying the removal of capital controls may well introduce complications that increase rather than decrease the total cost of adjustment.

Of particular importance for the sequencing of reforms in the New Zealand context have been the related considerations of monetary control and policy credibility. More specifically, at the outset of the reform programme in 1984, the control of inflation through an effective monetary policy was seen as a crucial element in the overall economic strategy.[27] Such a monetary policy was considered essential for the credibility and eventual success of the overall programme. In the second half of 1984, as large capital inflows continued to undermine the Government's attempts to run a tight monetary policy, it became clear that effective monetary control would only be achieved once the exchange rate was floated. The move towards a float in turn required that exchange controls be removed to allow the efficient operation of a private foreign exchange market.

The only possible alternative strategy for establishing an independent monetary policy would have been not only to maintain the existing fixed exchange rate policy and exchange control regime but also to extend the exchange controls, as proposed by McKinnon,[28] so as to restrict capital inflows severely.[29] This alternative was not seriously considered — for good reason. The credibility of the intended economic liberalisation programme could have been severely eroded had the programme started out with the introduction of yet further controls. Also, on the basis of the experience in attempting to stem capital outflows in the June quarter of 1984, it was obvious that only very extensive and draconian measures would have been capable of controlling capital inflows in the face of a significant interest differential.

The issue of monetary control and the need for liberalisation and stabilisation policies to reinforce each other points to a more general credibility problem that may arise with McKinnon's gradualist prescription. While this approach to liberalisation is in principle intended to give a consistent and hence credible policy package, Stockman[30] has argued that the credibility of a reform programme may in fact be enhanced if measures are adopted rapidly and in a forceful manner. While the benefits of a cold turkey treatment should not be overstated, it is certainly arguable in the New Zealand situation that early and decisive liberalisation measures gave a degree of momentum to the overall reform programme which in turn contributed to its credibility.

This line of argument is developed further by Deepak Lal,[31] who emphasises the political economy aspects of economic liberalisation. Lal highlights the pressures that may come to bear on government to reverse its policies if reforms are delayed on the basis of "technocratic" considerations. Under a slow and carefully graduated reform programme, there is every incentive for coalitions of protected economic agents to lobby against every step of the liberalisation programme in the knowledge that a delay in one area will stall the whole reform process. Under the alternative strategy of introducing reforms as quickly as possible within the bounds of given political and economic circumstances, there is less likelihood that the overall programme will stall, and there are strong incentives for adversely affected sectors (such as agricultural producers in New Zealand) to promote more rapid reform in the remaining protected sectors. At the same time, the credibility of the overall reform programme is likely to be more far-reaching under this approach than would be the case under a slower and more ordered strategy.

While the relative merits of the sequencing of reforms to date remain debatable, there would seem little doubt as to how best to proceed from the present juncture. All of the arguments in the "sequencing" literature emphasise the need to minimise the relative price distortions that arise from partial liberalisation measures and, in particular, from the persistence of restrictions in the slower adjusting markets for real goods and labour. An optimal strategy in present circumstances is therefore likely to involve a rapid completion of the reform process, in order that private rates of return, and hence the distribution of economic resources, may sooner than otherwise reflect underlying economic costs and benefits. This, of course, is not to suggest that market prices will ever fully reflect social costs and benefits. However, there remain a number of specific distortions resulting directly from government interventions which, if removed, could substantially improve the market-based allocation of resources.

An end to all import licensing and a rapid move to a low uniform tariff structure would help to ease the adjustment burdens that have been placed on exports and would spread the pressures of disinflation across a wider range of sectors. Over the 1985-88 period, exporters have faced shifts in relative prices that are probably not consistent with conditions likely to prevail once the full liberalisation programme is completed. In such an environment, import-substitute industries should not receive any more assistance than exporters; if import protection does remain higher than export assistance, New Zealand will fail to exploit potential gains from trade and consequently suffer a loss of potential income. Yet implementation of the liberalisation programme to date has involved rapid reduction in export assistance (the major agricultural subsidies were abolished in 1984/85, and most of the remaining assistance measures were phased out quickly) but slow progress in lowering import protection. This imbalance between export and import protection has placed an implicit tax on exports, thus promoting a less open economy, rather than the more open one originally envisaged. As the imbalance persists, the benefits of the liberalisation programme will continue to be diminished.

Although some progress has been made in increasing labour market competition and flexibility, there remain important legal impediments inhibiting labour market competition. Specifically, membership of a union having in excess of 1,000 members is compulsory for all individuals working in an organisation where a compulsory union membership ballot has been successful. In addition, although unions are entitled to elect to negotiate directly with individual employers, so as to gain higher wage increases, individual employers are not correspondingly entitled to opt out of national award negotiations to bargain directly with individual unions. These aspects of labour legislation make labour markets less flexible than they otherwise would be. Unemployed workers are prevented by compulsory unionism from undercutting union wage rates to gain jobs, and firms facing difficult trading conditions are unable to cite individual unions to negotiate below award pay rates. Union accountability to members is also diminished by the resulting difficulty that dissatisfied members face in leaving their union.

The legalised monopoly powers presently given to unions may well result in a higher natural rate of unemployment for New Zealand than would occur in a more flexible labour market. These monopoly powers are likely to be particularly costly in terms of lost output and employment during the next few years as disinflation and structural economic change continue. Both to reduce New Zealand's natural rate of unemployment and to lower the transitional unemployment costs of disinflation and structural change, compulsory unionism and the 1,000 member rule should be abolished and employers given the same rights as unions to cite the other party for out-of-award wage negotiations. These reforms would also be likely to increase competition amongst unions for members, giving workers better value union services.

Tax reform to remove the distortions that have discouraged saving and encouraged excessive investment in commercial buildings would also help to reduce adjustment costs and improve the allocation of resources. If interest payments and receipts were taxed on an inflation-adjusted instead of a nominal basis, the net supply of domestic savings (that is, net of domestic investment expenditure) could be expected to rise, with a consequent lowering of domestic real interest rates. Excessive investment in appreciating real assets would no longer be encouraged while the fall in real interest rates would help to promote productive investment and reduce pressures on the household and farming sectors. It might be noted that the alternative of a comprehensive nominal-based income tax (including a capital gains tax) could also work to eliminate the artificial incentive to invest in appreciating real assets. However, in the event that inflation was not always zero, such a tax system would continue to discourage saving by ensuring that all forms of saving had low or negative after-tax real returns.

Perhaps the most important contribution to higher savings and lower real interest rates will come from a continued commitment to fiscal responsibility. In the earlier discussion on the level and uses of savings, it was observed that net domestic savings continued to improve as a percentage of GDP from a deficit of 8.7 percent in 1984/85 to an estimated 2.0 percent in 1988/89. In the face of on-going dis-saving in the private sector, most of this improvement was achieved as a result of continued improvements in the Government's financial deficit. While private savings finally made a major contribution to the improving external deficit in 1988/89, it remains vital that the financial deficit be contained or reduced further. In particular, if long-term interest rates are to fall in line with recent reductions in inflation, both savers and borrowers must become convinced that lower deficits - and lower inflation - are here to stay.

5. Conclusion

Following a decade of poor economic performance, a wide-ranging programme of economic liberalisation was initiated in 1984 with the aim of establishing an environment of efficient and competitive markets, supported by consistent financial policies, that would facilitate a sustained improvement in New Zealand's productive potential.

Financial deregulation, monetary policy and exchange rate policy have played a crucial role within the overall reform programme. From the macro perspective, the financial reforms have aimed at achieving greater stability in the general level of prices while at the same time giving a more sustainable balance between national savings and investment. From the micro perspective, the aim has been to foster an effective price signalling mechanism and to allow a freer flow of both real and financial resources between alternative competing uses.

While the reform programme has significantly affected all sectors of the economy over the 1985-88 period, the long-term effects on national savings and productivity are not yet discernible. Major rationalisations have occurred in many sectors, and certain industries have expanded rapidly in the wake of financial deregulation, in particular, financial and business services and commercial construction. Other industries in the previously more highly protected sectors such as manufacturing and public sector services have contracted sharply. Furthermore, the Government's disinflationary monetary policy has continued to dampen overall economic activity, particularly in those sectors most exposed to interest rate and exchange rate pressures. Only in 1988 did these pressures begin to ease as a recovery in private savings brought the external accounts closer to balance and inflation was brought down to low single figures.

With the floating of the exchange rate in March 1985, the Government had, for the first time, a mechanism for achieving independent control over the domestic rate of monetary expansion and hence inflation. The implementation of the disinflation strategy, however, has been slow and not without incident. Difficulties have been encountered in interpreting monetary conditions during a period of rapid structural change, and variations in the degree of policy pressure have occurred. Attempts to exert consistent downward pressure on inflation have been further hindered by the expansionary effects of financial deregulation on asset prices, the introduction of GST in October 1986 and the continued insulation of some sectors of the economy from competitive forces.

While the floating of the exchange rate was successful in delivering an effective monetary control mechanism, it was apparently diverted from its intended role of signalling a sustainable allocation of resources between the traded and non-traded sectors. Persistent upward pressure was applied to the real value of the New Zealand dollar as a result of the disinflationary monetary policy and the relatively slow adjustment of goods and factor markets during the liberalisation process. This pressure only eased off in the second half of 1988 as the real exchange rate fell to more sustainable levels. It has been popularly argued that the upward pressure on the exchange rate could have been avoided if the liberalisation measures had been sequenced differently. However, the reality of both political and economic constraints meant that a delay in opening up the financial markets – to await full trade and labour market liberalisation – was not a viable alternative. The credibility of the overall programme required that an effective monetary policy be put in place as soon as possible and that an early momentum be established in the reform process. Given the patent ineffectiveness of capital controls in 1984, there were also major practical difficulties inherent in any attempt at re-regulating capital flows.

Furthermore, even if goods and labour markets had been freed up at an early stage in the reform programme, the inherently slow adjustment in these markets would still have generated transitional exchange rate pressures in the wake of financial deregulation and a tight monetary policy.

In considering policy alternatives to ease further the pressures on the exposed sectors of the economy and to promote a return to sustained growth, it is essential, first, to maintain consistently firm monetary and fiscal policies. Any reversal of macro financial policies would, at best, give a temporary boost to domestic activity and, at worst, substantially damage the prospects for a sustained non-inflationary recovery. Second, measures should be taken to spread the adjustment pressures across all sectors of the economy. A more even application of liberalisation measures across all goods and labour markets would help to minimise the on-going transition costs of relative price distortions while bringing forward the ultimate benefits of the reform process.

Notes

1. Organisation of Economic and Co-operative Development (OECD) economic and outlook tables.

2. Ibid.
3. Chronologies of financial sector reforms can be found in: Reserve Bank of New Zealand, *Financial Policy Reform*, Wellington, Government Printer, 1986; subsequent March issues of the *Reserve Bank Bulletin*.
4. Institution-specific interest rate controls were not removed until later; the 30-day rule and the 3 percent demand deposit restrictions on banks were abolished in August 1984 and the 3 percent interest rate ceiling on home, farm and fishing vessel ownership accounts was abolished in 1987.
5. Reserve Bank of New Zealand. *Annual Report*. Wellington, Government Printer, 1985.
6. While the Reserve Bank put relatively more emphasis on the monetary policy benefits of the float, the major concern of Treasury was to allow a greater degree of real exchange rate flexibility during a period of rapid structural change. See, for example: New Zealand Treasury. *Economic Management*. Wellington, Government Printer, July 1984.
7. An exception to the nil penalty operation of the credit guideline rule was made for finance companies. These institutions were individually subject to a 100 percent marginal ratio requirement in respect of all lending in excess of that permitted by the credit guideline.
8. Primary liquidity (PL) is defined to include bankers' cash balances at the Reserve Bank plus discountable government securities. Prior to December 1984, all government securities were discountable. During the year to December 1985, only government securities within six months to maturity were discountable. This qualification was phased down to one month by April 1986 and has remained at this level up to December 1988. However, with the introduction of Reserve Bank bills in late 1988, the definition of PL has undergone a further change: Reserve Bank bills of less than 29 days to maturity are now the only eligible discountable securities.
9. The discount margin is the margin above market interest rates at which government securities falling within the PL definition are discounted for cash at the Reserve Bank.
10. Cheque issuance was not fully contestable as a result of the trading bank monopoly on cheque clearance and the settlement system. Under the new banks policy, the Reserve Bank became willing to open settlement accounts for any institution, thus allowing the existing databank clearing system to be (potentially) contested.
11. The twelve new banks as at December 1988 were: Barclays Bank plc; Barclays Bank New Zealand Limited; Bankers Trust New Zealand Limited; Banque Indosuez New Zealand Limited; CIBC New Zealand Limited; Citibank N.A.; Countrywide Banking Corporation; Hong Kong and Shanghai Banking Corporation; Macquarie Bank Limited; NZI Bank Limited; National Australia Bank (New Zealand) Limited; State Bank of South Australia.
12. See, for example: Reserve Bank of New Zealand. *Financial Policy Reform*. Wellington, Government Printer, 1986, Chapter 9.
13. The real effective exchange rate index referred to is published in the *Reserve Bank Bulletin*. This index is an effective exchange rate index deflated by consumer prices and has weights that are calculated as a simple average of bilateral export,

bilateral import and global export trade weights. For more information on the construction of this index, see: Estimating New Zealand's real effective exchange rate. *Reserve Bank Bulletin*, Vol. 51, September, 1988.

14. See, for example: Jurgensen, P. *Report of the Working Group on Exchange Rate Intervention*. March 1983.
15. A survey of the evidence to 1983 is provided in: International Monetary Fund. *Exchange Rate Volatility and World Trade*. Occasional Paper 28. Washington DC, July 1985.
16. Cushman, D. O. The effects of real exchange rate risk on international trade. *Journal of International Economics*, Vol. 15, No. 1/2 (August), 1983, pp. 45-64.
17. Coleman, A. *The Effect of Exchange Rate Volatility on New Zealand Exports, 1981-1987*. (Paper presented to the New Zealand Association of Economists Conference, February 1988, Economic Department, Reserve Bank of New Zealand.)
18. Markets in forwards, options and futures contracts.
19. Williamson, J. *The Exchange Rate System*. Washington DC, Institute for International Economics, June 1985.
20. Cross-subsidisation between various products and services remains a common feature in the New Zealand banking industry.
21. For a discussion on this matter, see: Harper, D. A. *The Financial Services Industry: effects of regulatory reform*. New Zealand Institute of Economic Research, Research Paper 35, Wellington, 1986.
22. For example, the Countrywide Building Society has incorporated with the Bank of Scotland to gain a bank licence.
23. See, for example: • Buckle, R. A., Sequencing and the role of the foreign exchange market, *in* A. Bollard and R. A. Buckle (eds.) *Economic Liberalisation in New Zealand*, Wellington, Allen and Unwin, 1987, Chapter 11; • Karacaoglu, G. and Harper, D. A., Financial policy reform in New Zealand, *in* A. Bollard and R. A. Buckle, op. cit., Chapter 10.
24. • McKinnon, R. I., The Order of Economic Liberalisation: lessons from Chile and Argentina, *Carnegie-Rochester Conference on Public Policy*, No. 17, North Holland, 1982; • Kreuger, A. O., Problems of liberalisation, *World Economic Growth*, San Francisco, Institute of Contemporary Studies/ICP Press, 1984; • Mathieson, D. J., International capital flows, capital controls and financial reforms, *in* Hang Sheng Cheng (ed.), *Financial Policy Reform in Pacific Basin Countries*, Lexington Books, 1986; • Edwards, S., The order of liberalisation of the external sector in developing countries, *Essays in International Finance*, Princeton University, No. 156, December 1984; • Frenkel, J. A., Panel discussion on southern cone, *IMF Staff Papers*, Vol. 30, No. 1, March 1983.
25. Note that this real appreciation can occur whether the nominal exchange rate is either floating or fixed. In the first case, the capital inflows bid up the nominal and hence the real exchange rate. In the latter case, with the nominal exchange rate fixed, the capital inflow generates a domestic inflation relative to foreign inflation and hence a real exchange rate appreciation.
26. Edwards S., op. cit.; • Stockman, A. C., The order of economic liberalisation:

lessons from Chile and Argentina, a comment, *Carnegie-Rochester Conference Series on Public Policy*, No. 17, North Holland, 1982.

27. Kreuger (Kreuger, A. O., op. cit.) has noted that more attempts at trade liberalisation have faltered as a result of the failure of anti-inflation policies than any other single factor.
28. McKinnon, R. I. op. cit.
29. Controls on capital inflows at that time had been of a minimal nature; overseas borrowing by New Zealand residents for less than twelve months was prohibited, but this restriction was not effectively enforced.
30. Stockman, A. C., op. cit.
31. Lal, D. The political economy of economic liberalisation. *The World Bank Economic Review*, vol. 1, No. 2, 1987, pp. 273-299.

Chapter 5

FISCAL POLICY AND GOVERNMENT EXPENDITURE REFORMS

Bryce Wilkinson

LIKE MANY COUNTRIES, NEW ZEALAND initially reacted to the first oil shock (1973-74) with expansionary fiscal policies. Between 1973-74 and 1975-76, government expenditure rose from 27.7 percent of gross domestic product (GDP) to 38.1 percent. Meanwhile, the fiscal deficit ("Budget Table 2 basis") rose from 1.7 percent of GDP to 8.6 percent.

During the next eight-and-a-bit years, the Muldoon administration made periodic, but ultimately inadequate, attempts to rectify the solution. Many swings in fiscal stance occurred during this eight-year period around a common theme of generally poor quality, microeconomic policies and *ad hoc* approaches to expenditure containment such as across-the-board expenditure cuts. New Zealand's net official indebtedness rose sharply (see Table 1), a reflection of such fundamental policy failures.

Pressure to arrest this trend came both from overseas (for example, Standard and Poor's Corporation and Moody's Investment Services down-rated New Zealand sovereign debt in 1984) and, domestically, from the need to address, other than by direct controls, the associated political problems of inflation and high interest rates. Politically, the election in 1984 of a new Labour Government dedicated to abandoning the ways of the previous Muldoon administration provided an impetus for change.

The new Labour Government has addressed the fiscal problem by taking major new initiatives within the Public Service and state-owned enterprises and, as Tables 2 and 3 demonstrate, it has significantly reduced the fiscal deficit on a wide range of measures. Nevertheless, although senior ministers made strenuous efforts to curtail expenditure, with notable successes in some major areas, the statistics presented in this chapter indicate that total government expenditure has not been reduced relative to GDP (Tables 4 and 5) – the deficit reductions instead reflect higher revenue in relation to GDP (Table 6). Several new taxes, a major increase in non-tax revenue from increased administrative fees and charges, have driven the revenue increase.

Table 1 Trends in Net Debt (as a percentage of GNP)

	1973/74	1979/80	1984/85	1985/86	1986/87
Total New Debt					
New Zealand Official[1]	1.6	18.6	43.8	43.6	45.7
Local Government[2]	8.0	6.6	5.4	5.3	5.3
Total New Zealand Net Debt	**9.6**	**25.2**	**48.9**	**48.6**	**51.0**
OECD Average Net Debt[3]	16.5	21.2	30.7	32.2	33.5
OECD Average for Small Countries	12.0	22.2	33.7	35.4	36.8
NZ Official Net Overseas Debt[4]	**-1.6**	**19.4**	**30.9**	**29.9**	**27.0**
Memorandum Item:					
Gross Domestic Product ($m)	9,199	19,715	38,729	44,255	52,879

Notes:

[1] New Zealand Official Net Debt: New Zealand Planning Council (NZPC) "Tracking Down the Deficit" to 1985/86. Treasury calculations for 1986/87. The debt is net of official overseas assets and net of public account domestic financial claims.

[2] Local Authority Net Debt: Department of Statistics Estimates 1985/86 and 1986/87 based on 1984/85 data.

[3] OECD.

[4] NZPC pp. 74 and 85 to 1985/86. March quarter 1988 *RBNZ Bulletin* (March quarter 1988), pp. 47 and 49 for 1987 debt ($14,278.4 million) and Table 2B for 1986/87 GDP.

Source:

Government Management. (Brief to the Incoming Government 1987). Vol I: The Treasury, p. 230.

Table 2 IMF Government Finance Statistics: Budget Balances

March Year	Current Account Surplus(+)	Net Financial Surplus(+)	Lending - Repayments (+)	Overall Surplus (+)	Gross Domestic Product	Current Account Balance	Net Financial Balance	Overall Balance
	$m	$m	$m	$m	$m	% GDP	% GDP	% GDP
1975	409	17	-433	-416	10,028	4.1	0.2	-4.1
1976	22	-370	-828	-1198	11,669	0.2	-3.2	-10.2
1977	407	7	-421	-414	14,105	2.9	0.0	-4.4
1978	373	-79	-710	-789	14,885	2.5	-0.5	-5.3
1979	-266	-753	-749	-1502	16,850	-1.6	-4.5	-8.9
1980	-39	-511	-616	-1127	19,697	-0.2	-2.6	-5.7
1981	-375	-925	-616	-1541	22,944	-1.6	-4.0	-6.7
1982	-695	-1322	-789	-2111	27,831	-2.5	-4.8	-7.6
1983	-967	-1673	-716	-2389	31,240	-3.1	-5.4	-7.7
1984	-1402	-2384	-825	-3209	34,329	-4.7	-6.9	-9.3
1985	-1551	-2449	-784	-3233	38,667	-4.0	-6.3	-8.4

Continued Table 2

Table 2 IMF Government Finance Statistics: Budget Balances

March Year	Current Account Surplus(+)	Net Financial Surplus(+)	Lending - Repayments (+)	Overall Surplus (+)	Gross Domestic Product	Current Account Balance	Net Financial Balance	Overall Balance
	$m	$m	$m	$m	$m	% GDP	% GDP	% GDP
1986	-498	-1397	-685	-2082	44,868	-1.1	-3.1	-4.6
1987	871	-1866	-122	1988	52,879	1.6	3.5	-3.8
1988	77	-1147	1789	642	59,200	0.1	-1.9	1.1

Sources:

Budget tables. GDP from March 1988, Monthly Abstract of Statistics to 1986/87. NZIER March 1988 "Quarterly Predictions".

Table 3 Measures of Fiscal Balance

IMF GFS Data - March Years	1983/84	1984/85	1985/86	1986/87	1987/88[4]
Conventional GFS Fiscal Balance - $m	-3,209	-3,235	-2,082	-2,017	+579
As a percentage of GDP	-9.3	-8.4	-4.6	-3.9	+0.7
Financial balance[1] - $m	-2,384	-2,451	-1,397	-1,894	-1,271
As a percentage of GDP	-6.9	-6.3	-3.1	-3.7	-2.2
Inflation - Adjusted Financial Balance[2] - $m	-2,050	-1,300	-200	+400	+100
As a percentage of GDP	-6.0	-3.4	-0.4	+0.8	+0.2
Cyclically and Inflation-Adjusted Financial Balance[3] - $m	-1,700	-1,350	-500	+400	+600
As a percentage of GDP	-5.0	-3.5	-1.1	+0.8	+1.0

Notes:

[1] Conventional Fiscal Balance excluding Net Lending.

[2] Financial Balance minus the Inflation Adjustment (rounded to the nearest $50 million).

[3] Financial Balance minus the Inflation Adjustment *for cyclical fluctuations* (rounded to the nearest $50 million).

[4] Budget night forecast.

- IMF GFS Data - *Government Finance Statistics Yearbook* and Treasury estimates

- Nominal GDP (after Stock Valuation Adjustment) - Department of Statistics estimates and Treasury forecasts of $51,800 for 1986/87 and $57,600 million for 1987/88

- Inflation Adjustment - Treasury estimates to 1986/87 and Treasury forecast of $1,350 million for 1987/88

- Cyclical adjustment - estimates and forecasts prepared by the Treasury based on adjustments for the five years of +$350 million, -$25 million, -$300 million, -$25 million and +$475 million respectively. This is based on a trend rate of growth of 2.7 percent from 1979/80 to 1987/88.

Source:
1987 Budget, Part 1, p. 32.

Table 4 Summary of Expenditure Growth 1984/85 - 1987/88 (As a percent of GDP)

	1983/84	1987/88	Comments
By Function			
General Public Services	3.0	6.5	Major lift in 1987/88 reflecting GST.
Defence	2.0	2.0	
Education	4.9	5.2	Increased staff.
Health	5.2	5.7	
Social Security & Welfare	12.0	13.5	Increased Family Support
Housing & Community Amenities	0.4	0.9	Expansionary housing policies.
Other Community & Social Services	0.1	0.3	Expanded services
Economic Services	7.2	4.3	Cut-backs from November 1984 Budget
Other Purposes (Interest, etc.)	6.2	8.6	Effect of escalating debt spiral and major project debt
Total Functional Spending	41.1	47.0	
Economic Classification			
Wages & Salaries	7.1	7.1	Increased by redundancies
Other Goods & Services	3.4	5.4	Partly effects of GST
Interest Payments	5.9	8.4	Continued strong growth
Subsidies & Other Current Transfers	22.4	23.9	Reduced ec. services offset by increased social services
Total Current Expenditure	38.8	44.8	
Capital Expenditure	2.3	2.2	
Lending Minus Repayments	2.4	-3.0	Asset Sales and Commercialisation SOEs
Total excluding Net Lending	41.1	47.0	
Total including Net Lending	43.5	44.0	

Table 5 Underlying Trends in Net Expenditure

	1985/86 $m	1987/88[1] $m
Budget Net Expenditure	17,672.3	27,507.1
(as % of GDP)	(39.4)	(47.8)
Less Adjustments		
Major Project & Producer Board Debt	-	4,600
Public Sector Reorganisation	241.7	652.9
Asset Sales & Net Lending	666.5	-1,757
Tax/Benefit Measures	-165	525
GST – additional costs	-	1,020
Sub-Total	16,929	22,466
(as % of GDP)	(37.8)	(39.0)
Less		
Cyclical & Temporary Factors	-320	90
Adjusted Net Expenditure	17,249	22,326
(as % of GDP)	(38.4)	(38.8)

Note:

[1] Budget night forecast.

Source:

1987 Budget, Annex 2, p. 43.

Table 6 Summary of Revenue Growth 1984/85 – 1987/88 (As a percent of GDP)

	1983/84	1987/88	Comments
Current Income			
Individuals	19.5	19.3	Fiscal drag given back in tax cuts
Corporate	2.0	3.4	Closure of loopholes
Other	0.1	0.3	
Payroll/Manpower Taxes	-	0.4	Fringe Benefit tax from 1 April 1985
Property Taxes	0.4	0.6	
Taxes on Goods & Services			
GST	-	6.5	Imposition 10% GST, 1 Oct 1986
Other Sales Taxes	3.8	-	Replaced by GST
Excises	2.6	4.2	Includes some sales taxes on motor vehicles

Continued Table 6

Table 6 Summary of Revenue Growth 1984/85 - 1987/88 (As a percent of GDP)

	1983/84	1987/88	Comments
Motor Vehicles Taxes	0.3	0.2	
Other Goods Taxes	0.0	0.1	
Taxes on International Trade			
Import Duties	1.3	1.5	
Other	0.1	0.0	
Non-Tax Revenue			
Property Income	2.7	4.5	
Administration Fees & Charges	0.7	3.5	Application of user-pays
Other	0.2	0.2	
Capital Revenue	0.0	0.1	
Sub Totals			
Current Income Tax Revenue	21.7	23.0	Mainly increase corporate tax
Other Taxes	0.4	1.0	
Taxes on Goods & Services	7.0	11.1	Net effect of GST reform
Taxes on International Trade	1.4	1.6	
Non-Tax Revenue	3.6	8.3	User-pays
Capital Revenue	0.0	0.1	Some asset sales
Total Revenue	34.2	45.0	

This chapter provides:

- an outline of the scope of the fiscal position, and the accumulated debt burden, inherited by the new Government in July 1984;
- a chronology of major fiscal announcements and measures from July 1984 to December 1988 (the appendix to this book provides more details);
- a summary of key trends in government expenditure and revenue since the year ended March 1984; and
- a preliminary discussion of the policy framework in which fiscal policy has been approached during this period, with particular comments on Keynesian macro-stabilisation issues, the speed of deficit reduction, optimal deficit (and debt) targets and government expenditure objectives.

The scope of the 1984 Government Fiscal Problem

When the Labour Government took office in July 1984, it inherited the following fiscal situation:

- A July 1984 forecast 1984/85 fiscal deficit (on the Government's own "Table 2 basis") of 6.2 to 7.6 percent of GDP following a 9.1 percent 1983/84 fiscal deficit.[1] On the more internationally comparable International Monetary Fund's Government Finance Statistics (GFS) basis, the overall fiscal deficit turned out, in 1984/85, to be 8.4 percent of GDP compared with 9.3 percent in 1983/84 (see Table 3).

- Total gross official debt at 31 March 1984 of $21,981.2 million, amounting to 64.7 percent of 1983/84 GDP of $34,313 million – up from (a 1970s low of) 39.1 percent in 1973/74. Of this debt, $9,387.9 million was owed externally in foreign currencies. By 1984, few countries in the OECD region could match New Zealand's level of gross official indebtedness in relation to GDP and, out of a list of thirteen of the small industrial OECD countries, only Ireland could claim a higher ratio for the foreign debt component.[2]

- Net official debt, defined as gross debt, less official overseas assets and a book value of public account domestic financial claims, was up from 1.6 percent of GDP on 31 March 1974 to 35.3 percent by 31 March 1984. Net official overseas debt rose from –1.6 percent of GDP (surplus of assets) to 24.5 percent during the same period.[3]

- Forecast 1984/85 (Table 1) net government expenditure totalled $15,020 million, 41.7 percent of forecast GDP of $35,994 million, up from a 35.4 percent average during 1975/76.[4]

- Contrary to the impression which may be given from the above statistics, the previous Muldoon administration did not go on a spending spree within the traditional state-spending activities. Rather, the mounting debt problem during the last decade reflected the Government's inability to eliminate, on a sustainable basis, the 1975/76 deficit it inherited when it first took office in November 1975. Debt servicing and increases in social services expenditures accounted for much of the growth in government outlays relative to GDP which did occur during the decade to 1985. The growth in debt servicing reflected the large, near-chronic, fiscal deficits during this period. Social service expenditures rose sharply in 1977/78 when expenditure on a new National Superannuation scheme rose to 6.2 percent of GDP, up from 1.4 percent of GDP in 1975/76 – the last full year of the previous superannuation scheme.[5] Note, however, that National Superannuation provided a taxable benefit in place of previous benefits, which included a tax-free benefit, so that the above comparison overstates the net fiscal cost of National Superannuation.

- For many years, central government's share of value added (that is, excluding transfer payments) had been about 20 percent of GDP – reflecting a comparable figure for public sector employment in total employment. Some of the largest enterprises in the nation were entirely state owned, including the Post Office, the New Zealand Electricity Department, Petrocorp, the Forest Service, the Railways Corporation, the largest trading bank (the Bank of New Zealand) and many other financial institutions.

In fact, the underlying fiscal position the Government faced in 1984 was appreciably worse than indicated by the above statistics. The previous Government borrowed extensively overseas to defend the exchange rate, and it had committed the taxpayer to several billion dollars of contingent liabilities based on gambling that world agriculture, oil and steel prices would rise appreciably.

In the event, the exchange rate proved unsustainable at the fixed level of 78.4 against the Reserve Bank's trade-weighted basket, and the new Government immediately incurred, on devaluing 20 percent, considerable losses (via the Reserve Bank) on forward cover contracts and on government stock bought back at artificially low interest rates prior to the devaluation. Translation losses on the stock of outstanding foreign currency-denominated debt also occurred. Primarily as a result of these events, net official overseas debt rose 44 percent from $8.3 billion at 31 March 1984 to $12.0 billion at 31 March 1985.[6]

The Accumulated Debt Position

By 31 March 1985, net official debt reached 43.8 percent of GDP. It rose further when, in the 1986 Budget, the Government announced that it was assuming direct responsibility for $7.2 billion of private sector and quango debt incurred by the primary product producer boards, New Zealand Steel and on various energy projects encouraged by the previous Government. By 31 March 1987, the net official debt had climbed to 45.7 percent of GDP (Table 1).

Growing public awareness of the magnitude of the debt problem has, inevitably, led various politicians and commentators to spend considerable resources on producing debt statistics which put their favoured position in the best possible light. This task has been aided by the timing differences, by which policies taken by one administration can affect the increase in debt incurred by a subsequent administration, and by different statistical measures of debt such as gross and net debt, domestic and foreign debt, public debt (non-Reserve Bank), official debt (includes the Reserve Bank) and total (public plus private) debt.

Focusing on gross official debt is unsatisfactory in that overseas assets have been significantly increased since the July 1984 foreign exchange crisis.[7] Net indebtedness, while more difficult to measure, must provide a better measure of underlying changes in public sector net worth and/or potential future tax burdens. This fiscal policy chapter focuses, therefore, on net official indebtedness. In this context, the magnitude of the debt burden in 1987 was probably best summarised in Table 1, prepared by the Treasury, and in the following comment from *Government Management*:

> . . . official indebtedness will also increase as a result of the likely need to write down financial assets associated with the Rural Bank and Housing Corporation restructuring and the likely absorption of some Railways Corporation and National Provident Fund debt associated with the restructuring of these entities. While decisions have yet to be taken on some of these issues, rough estimates suggest that net debt (including local authorities) is likely to amount to 60 percent of GDP by the end of the 1987/88 year. On this basis this makes New Zealand the fourth most indebted country in the OECD.[8]

This would put the 31 March 1988 net official debt at $35-36 billion. The statistics quoted here, and provided in Table 1, measure gross official debt less overseas official reserves and domestic government financial assets. These financial assets include very large (book) claims accumulated against government agencies. The major portion of these claims is accounted for by the Government as loans to the Rural Bank, Housing Corporation, the old New Zealand Electricity Department (now Electricorp) and the Post Office (now Telecom, New Zealand Post and Postbank).

Valuations of these and other state-owned entities during the corporatisation process confirm that their assets are worth only a fraction of the *nominal* amounts originally invested. Even so, they are still substantial. On 17 December 1987, the Government indicated that it could reduce the (gross) public debt (of $42 billion on 31 March 1987) by about one third ($14 billion) through asset sales. (Note that this would not reduce *net* indebtedness.) The Government would still own considerable assets, including roads, schools, hospitals, land and mineral rights, but, on the other hand, central government would also face considerable contingent liabilities in terms of superannuation, accident compensation schemes, earthquake and war damage insurance, Maori land claims and liability for many debts incurred under government guarantees or by state-owned enterprises.

On this basis, central government net worth could well be negative, although considerable research would be required to substantiate such a conclusion. Nevertheless, it is difficult to see that New Zealand has much of lasting value, in the way of increased net physical or human capital, to show for the vast increase in net indebtedness since 1974.

In 1987/88 dollars, the difference between the 1973/74 net indebtedness of 9.6 percent of GDP (Table 2) , and the 60 percent estimate above, amounts to $30 billion using a 1987/88 GDP forecast of $59,200 million (Table 2). This represents an increase of $30,000 per household - roughly three times the annual income tax burden per household. Of course, these figures do not represent the aggregate national dis-saving in respect of government activities - that is better indicated by the substantially increased New Zealand government debt held by overseas residents.

In the past, reflecting a variety of restrictive regulations, the capital market in New Zealand government debt has been severely segmented, with overseas residents probably holding all the foreign currency-denominated New Zealand sovereign debt and resident entities holding the vast majority of New Zealand dollar-denominated government debt. Under deregulation, the latter side of this segmentation is starting to break down, but the growth of foreign currency-denominated public debt during most of this period is probably still a reasonable indicator of the degree to which government activities in the last fifteen years have reflected national dis-saving in respect of government activities.

The rise in net official overseas debt, between 1973/74 and 1986/87, as a ratio of GDP, of about 29 percent (Table 1) represents almost $17,000 per household - still a formidable amount. Asset sales used to reduce official overseas debt will now be reducing this statistic - but probably not the underlying burden.

The portion of the increased net indebtedness owed *within* New Zealand represents a transfer of wealth within the country, but not over time. Conceivably, a government could repudiate it and/or inflate it away, which would impose losses on the holders of the debt, at that time, to the benefit of taxpayers - an intra-generational transfer as distinct from an inter-generational transfer. Inter-generational transfers arise when one generation depletes the stock of useful assets, skills and technologies. Transfers of financial assets between generations do not generally come into this category. Conceptually, they could be cancelled without altering the productive capacity of the economy.

However, claims by foreigners on residents do represent potential future resource transfer in favour of the foreigners. In this sense, the $17,000 per household rise in net official overseas debt, calculated above, suggests a significant potential inter-generational transfer, particularly since it seems likely that net private sector overseas indebtedness has also been rising, and it seems doubtful that assets capable of servicing this debt have been created against it.

In summary, the following conclusions about New Zealand's indebtedness seem reasonable:

a) public sector net worth has dropped sharply (in real terms) during the past decade;

b) net official external indebtedness has risen markedly;

c) the rate of increase in net government indebtedness relative to GDP has been greatly reduced since 1984/85 (see Tables 2 and 3 on the net financial deficit); and

d) rising debt and much increased nominal interest rates have sharply increased net interest payments in relation to fiscal revenue and to GDP.

Chronology of Fiscal Policy Measures of the Lange Administration*

On taking office in July 1984, the Government immediately commenced work on cutting back government spending by reducing industry assistance through the lowering, or abolishing, of subsidies, including tax expenditures; moves to put government-provided services on to a user-pays basis by increasing government charges; and efforts to limit reliance on import licensing protection for domestic manufacturing.

In the November 1984 Budget, considerable emphasis was put on the principle of trying to reduce assistance to land-based industries at a similar rate to reductions occurring in assistance provided to other sectors. The underlying aim was to improve resource allocation while reducing the fiscal deficit by moving to more even, and lower average, rates of assistance across private sector activities so that prices would more accurately reflect resource costs. A new fringe benefits tax was introduced from 1 April 1985.

A detailed table provided in Annex 1 of the November 1984 Budget indicated that the measures taken on budget night would reduce the 1984/85 (Table 2) fiscal deficit by $172 million, the 1985/86 deficit by $1,075 million and the 1986/87 deficit by $1,761 million (all in 1984/85 prices). These reductions were extensive against the Budget's forecast 1984/85 deficit of $2761.3 million (out-turn $2,783 million). However, although the June 1985 Budget confirmed significant progress in reducing the fiscal deficit (to an out-turn of $1,871 million), and did extend the practice of user pays for government services, it also appreciably increased social services spending.

This theme of giving ground on social spending to gain support for tougher decisions in other areas was even more apparent in the major taxation and benefit reforms announced in August 1988 when the opportunity to use some of the $2,700 million full-year revenue from a major new tax (the 10 percent Goods and Services Tax, introduced from 1 October 1986) to reduce the fiscal deficit was lost in income tax reductions and benefit increases. The overall effect of the reforms introduced in association with this new tax was to increase the 1986/87 deficit by $1 billion (with a full-year impact of $737 million).[*]

On 19 May 1986, the Government released a *Statement on Government Expenditure Reform* which it (probably fairly) claimed resulted from "the most detailed and comprehensive vote-by-vote scrutiny (of government expenditure) in recent history".[10] Characteristically, the Government "rejected across-the-board cuts . . . [and] . . . sinking lids on staff numbers . . . [as] . . . arbitrary and ineffective substitutes for the sound and principled fiscal management required by responsible government".[11] The decisions taken were expected to reduce the financing requirements of net government expenditure by around $900 million in 1986/87, $1200 million in 1987/88 and $1400 million in 1988/89 – all in 1986 dollars. However, the real resource savings would be appreciably less than this, as some of the reductions merely reflected greater direct recourse to financial markets by state-owned enterprises.

In the final lead-up to the July 1986 Budget, which also introduced significant measures to reduce tax avoidance and evasion, further savings measures amounting to $800 million for 1986/87, and based on the principles underlying the 19 May Statement, were introduced. Despite this vigorous action to prune (primarily non-social policy) expenditures, the Government found itself obliged to take on $7,200 million of debt from projects initiated by the previous Government. The upshot was a further sharp increase in debt servicing costs and an increase in the forecast fiscal deficit for 1986/87.

On 29 October 1986, the Government announced, as a significant anti-tax avoidance measure, a major new accrual-based tax for business arrangements.

In the 18 June 1987 Budget, the Government announced, and subsequently achieved, the first forecast fiscal surplus for thirty-five years. However, as the Budget statement freely acknowledged, the

* The appendix to this book provides a detailed chronology of major fiscal policy measures taken since July 1984.

result greatly relied on asset sales and forcing many state-owned enterprises to raise a greater proportion of their funding requirements directly from the private market. A more meaningful measure of the progress made in reducing the deficit was the reduction in the GFS-based net financial deficit to $1,147 million or 1.9 percent of GDP in 1987/88 – down from $2,384 million or 6.9 percent of GDP in 1983/84 (see Table 2).

Even better, conceptually, but hazardous empirically, are the inflation and cyclically adjusted deficit measures presented by the Government in Table 3. These measures indicate that a fiscal surplus has been achieved in inflation-adjusted terms during the last two years. This result arises because double-digit inflation in those years means that over $1 billion of interest payments on debt can be regarded as (real) principal repayments. *If inflation drops sharply, this adjustment will be much smaller implying, for a time, a larger real underlying deficit than that indicated by Table 3.*

Most recently, in March 1988, the Government passed the State Sector Act, which could fundamentally alter incentives amongst public sector managers by reducing their tenure and making them more accountable to ministers.

Principles Guiding Fiscal Policy Decision

To an unusual degree, at least in a New Zealand context, the above fiscal policy decisions reflected carefully developed principles. These were clearly spelt out on many occasions, but the 1986 Budget Economic Commentary and the May 1986 *Statement on Government Expenditure Reform* provide useful summaries. For example, the Economic Commentary stated that the Government's broad policies reflected the following broad principles:

- fostering responsible fiscal and monetary management, directed towards sustainable low inflation and efficient public sector management;
- improving the responsiveness of the economy to changing market conditions;
- increasing opportunities for competition.

In managing its own affairs the Government's responsibilities include:

- ensuring that its expenditure programmes are effectively targeted and efficiently managed;

- levying taxes in a manner that is as even-handed as possible between different activities and different forms of income;
- financing its expenditures in a manner which is non-inflationary;
- maintaining a consistent and well-co-ordinated approach to both monetary and fiscal policy.

The key elements of the major reforms in public sector management behind the May 1986 measures were listed thus:

- state-trading enterprises are to be placed on a proper commercial basis, being exposed to competition on equal terms with the private sector and required to earn a market rate of return for the taxpayer;
- charges for many services, which are currently provided free or below cost at the taxpayer's expense, should be increased to cover the true cost of supply (including the cost of capital);
- non-commercial departments are to be given incentives for better asset management;
- some overall reductions in funding are to be imposed to encourage increased efficiency in administration;
- as part of an on-going programme of scrutiny, some quangos are to be abolished and the future of others reviewed.

Key principles announced on 12 December 1985 to drive reforms of state-owned enterprises stated that:

- responsibility for non-commercial functions will be separated from major trading state-owned enterprises;
- managers of state-owned enterprises will be given a principal objective of running them as successful business enterprises;
- managers will be given responsibility for decisions on the use of inputs and on pricing and marketing of their output within the performance objectives agreed with Ministers, so that managers can be held accountable to Ministers and to Parliament for their results;
- the advantages and disadvantages which state-owned enterprises have, including unnecessary barriers to competition, will be

removed so that commercial criteria will provide a fair assessment of managerial performance;

- individual state-owned enterprises will be reconstituted on a case-by-case basis in a form appropriate for their commercial purposes under the guidance of Boards comprising, generally, members appointed from the private sector.

Some Comments on the Principles and the Effectiveness of the Measures

The principles enunciated were unusual in the New Zealand context in that they were based on maximising national benefits rather than maximising the benefits to public revenue. For example, faced with the choice between taking the $7,200 million debt from major loss-making projects into the Government's own accounts at the taxpayers' expense, or of providing sufficiently high tariff and import-licensing protection to allow the affected industries to service their debt at their customers' expense, earlier governments might well have opted for the latter. Also, many governments would have been tempted to try to maximise revenue from asset sales by selling enterprises with entrenched monopolistic advantages. However, such an approach would clearly be welfare-reducing and would be inconsistent with the principles set out above.

Above all, the practical advantage of proceeding according to clearly specified principles is that they provide a comprehensive framework which develops a momentum of its own; any one government entity can hardly object to them once they have been widely applied to others. In contrast, *ad hoc* approaches cannot command such respect from "spending" ministers and departments. In the event, such principles were supported by many in the spending departments because they saw them as offering the prospect of greater autonomy, greater clarity of objectives and better rewards for performance.

Nevertheless, the serious difficulties involved in trying to effectively monitor state-owned enterprises and apply effective sanctions to poorly performing chief executives make it likely that the commercialisation of these organisations is a second-best alternative to privatisation. In this sense, considerable time has been lost in the commercialisation process. New Zealand has undoubtedly lagged well behind the international trend towards privatisation.

However, against the alternative of the status quo, commercialisation has undoubtedly been a major success. Although many of the changes, as they affect the Government's overall financing requirement, are mainly window-dressing in the short term; more fundamental indicators point to very considerable potential savings. In the first place; the Government has been successful in involving leaders of the business community on the boards of many of these organisations. Private sector commercial expertise is also making its presence felt at management level.

The first, most visible, sign of radical change has been widespread redundancies in the public sector – except for the social policy areas. The major public sector union, the Public Service Association (PSA), was reported as claiming that almost 20,000 jobs have disappeared (Railways 5,000; Forest Service and State Coal 5,000; Ministry of Works and Development 3,500; New Zealand Post 2,200; Electricity Corporation 1260; Ministry of Agriculture and Fisheries 600; Department of Social Welfare 1100; Customs 330, Labour Department 188; and "others" at least 500).[12] The accuracy, or true meaningfulness of such figures cannot readily be determined from outside the Public Sector, and they must be put in the context of a total central government sector work force of over 200,000.

Within the Public Service itself (that is, excluding state-owned corporations) a spokesperson for the State Services Commission reported that (as of April 1988) no public servant had actually been fired but that 9,781 public servants, including wage workers, had been "displaced" by the Government's restructuring programme. This could be scaled against the 85,738 public servants (including wage workers) at 31 March 1984.[13] However, the Commission reported that a very substantial portion of these displaced workers had been, or would be, redeployed within the public services and others might take voluntary severance, early retirement and/or retraining.

Also importantly, the new chief executives report significant savings from stopping unsound planned capital expenditure projects. Simple devices like charging departments for office space can lead to radical reassessments of the need to use expensive Central business district office space for storage purposes.

In some cases, there can be no doubt that radical changes have occurred. For example, it is claimed that "the corporatised forestry service cut its workforce from 7,000 to 2,700 without reducing output. Before corporatisation, it required a government cash injection of about $70 million a year. In its first six months of corporatisation, it showed a $24 million surplus."[14]

Although it is too early to assess the full consequences of the reform process, it seems clear that things can never be quite the same again for most public servants. In the first place, their job security is now clearly not inviolate. Secondly, much information has been produced about how poorly resources have been managed within the public sector – the common refrain in the valuation of the state-owned enterprises has been that their assets were worth significantly less than the amounts spent on them, net of dividends and interest. Thirdly, the injection of private sector management expertise and personnel will bring with it much-needed commercial expertise. Finally, the recently passed State Sector Act puts senior public service executives on a contract basis, significantly improving incentives for these people to serve their ministers well.

A broader look indicates that the implementation of the Government's fiscal strategy has undoubtedly substantially reduced the fiscal deficit since 1983/84, according to all the customary deficit measures but, as shown in Tables 4 and 5, the effect of all these measures on *government expenditure* has been mainly to change its composition rather than its level in relation to GDP. However measured, government expenditure has clearly increased faster than GDP, with strong growth in debt servicing and social services expenditures outstripping reductions in expenditures on economic services from the 1984 Budget and expenditure savings from the 1986 expenditure reviews.

In part, the increased expenditure reflects temporary factors - such as large state sector redundancy payments and permanent structural changes - for example, the requirement that government departments pay GST and the move to account for some benefits as government expenditure rather than as reduced tax revenues. Even so, a table supplied in the 1987 Budget and summarised in Table 5 indicates that government expenditure, broadly defined, has risen as a percentage of GDP from 38.4 percent in 1985/86 to 38.8 percent in 1987/88, even when all the above factors are explicitly removed. Another analysis indicates that government expenditure, adjusted to reflect a better measure of its tax burden, would rise to 42.7 percent of private income in 1987/88, up from 39.6 percent in 1985/86.

The reductions in the net financial deficit since 1983/84 reflect increased tax and other revenues in relation to GDP as indicated in Table 6. The projected 1987/88 surplus in the overall deficit results from the additional element of large asset sales and loan repayments by state-owned enterprises.

In conclusion, the New Zealand experience from July 1984 to the present demonstrates the difficulties of trying to contain government expenditure when social policy is near-sacrosanct, there is a large fiscal deficit, a massive stock of debt has accumulated and nominal interest rates exceed the nominal growth rate. While continued asset sales may obscure the underlying reality for a year or two, New Zealand still appears to face a precarious fiscal situation involving a continuing need to increase taxes in relation to GDP and/or to reduce expenditure. In any case, welfare maximisation requires a serious scrutiny of the equity and efficiency of current social policy expenditures.

The Speed of the Deficit Reductions

The on-going battle to contain the public debt spiral by reviewing expenditures, improving the tax structure, raising average tax rates and reducing marginal tax rates has raised questions about the speed of the deficit-reduction process and the medium-term target for the deficit (and for the net public debt). Although the opponents of change argue that efforts to reduce the debt have occurred too quickly, others have suggested that the continuing deficit, in conjunction with a disinflationary monetary policy, has aggravated upwards pressure on interest rates and the exchange rate to the great discomfort of the traded goods sector. For the latter group, the fiscal deficit needs to be sharply and quickly reduced.

Indeed, the evidence provided in this chapter demonstrates that some large sectors, or clients, of the public sector have received considerable additional resources at a time when tax burdens and government charges have appreciably increased. This certainly suggests that some of the pressures being experienced by the exposed sectors of the economy do reflect fiscal decisions.

Although policies to reduce a fiscal deficit would be generally thought, in a conventional Keynesian model, to be contractionary, more sophisticated theoretical models of (rational) expectations question the proposition that deficits raise real economic activity in a predictable way, even in the short term.

In practice, large, on-going fiscal deficits are usually a sign of poor economic management. Also, they raise increasing doubts amongst lenders as to repayment probabilities and amongst financial markets as to how the policy dilemmas which lead to large deficits will be eventually addressed. Frequently, contrary to the Keynesian stabilisation notion, hard-headed measures to reduce the deficit do not take effect at a cyclical peak in activity – instead, they tend to be taken when adverse circumstances and opportune political circumstances combine to justify moves to a more sustainable fiscal position.

Frequently, large, on-going deficits become associated with political instability, inflationary fears and a flight of capital (and/or a depreciating currency). In this context, credible policies to reduce a fiscal deficit in a determined and coherent manner may conceivably generate greater investor confidence and higher domestic spending than policies which fail to address the problem.

In the New Zealand context, Treasury has suggested,[14] presumably on pragmatic credibility grounds, that a reduction in the fiscal deficit of at least 2 percent a year would be desirable. Past experience in New Zealand (notably in 1976/78) suggests that an overly rapid rate of deficit reduction may not be sustainable given the amount of effort required to develop, market and apply the basic principles necessary for effective public sector reform.

However, the Treasury's indicative minimum undoubtedly excluded deficit reductions associated with changed accounting practices, such as having state-owned enterprises fund themselves outside the public accounts. In this sense, the inflation-adjusted GFS net financial balance is probably a better statistic for evaluating the speed with which the Government has reduced the deficit.

On this basis, the inflation-adjusted deficit has dropped from 6.0 percent of GDP in 1983/84 to a projected 0.2 percent surplus for 1987/88 (see Table 3) – a drop of about 1.5 percent a year. Arguably, the achievement is greater than this in that the 1983/84 figure excludes interest on the $7.2 billion of major project debt picked up by the taxpayer in the 1986 Budget. At a 4 to 5 percent (real) rate of interest, this would have increased the inflation-adjusted deficit by about 1 percent of GDP, or .25 percent a year spread over four years. Hence, the achievement would still appear to fall short by 2 percent a year.

More importantly, as inflation falls, the calculated real interest burden on the large stock of existing fixed coupon government stock will rise rapidly. At a zero rate of inflation in 1987/88, the inflation-adjusted deficit would be 2.2 percent of GDP. Given that real interest rates appear to exceed substantially the current real economic growth rate, a resumption of growth in real net indebtedness seems likely as inflation falls, unless the underlying net financial deficit can be converted into a sustained surplus.

Other perspectives on the speed of deficit reduction can possibly be based on considerations of the desired end-target for net public sector indebtedness. Here, two conceptual approaches may apply. The first is the ethical one of whether or not we can, in good conscience, force our children to pay for our current consumption. James Buchanan recently argued strongly that the founding principles and values of a society of free persons requires acceptance of the benefit principle – namely that those who benefit from a policy should be required to finance such benefits.[17] (Borrowing to finance capital investments or extraordinary demands such as war emergencies could be ethically permissible, however.) The essence of Buchanan's concern with public-debt-financed consumption is that it can be used (to a much greater degree than can private debt) to impose an external cost on others. In particular, the costs can be shifted onto future generations via increasing overseas indebtedness – raising serious moral and ethical problems.

On this basis, the data above strongly suggest that, as a nation, we should be reducing net external indebtedness (in relation to GDP) so that the costs of past policies do not entirely escape the generations which benfited from them. By running a sustained net financial fiscal surplus, the Government could contribute to the net saving position New Zealand would have to achieve in order to run a current account surplus in the balance of payments.

The second conceptual approach to examining the question of an optimal level of net public sector indebtedness would be to adopt the financing norms prevalent in the private sector. The Government, therefore, could adopt a debt/equity ratio in financing its assets which closely reflects that which the private sector would use for those assets. In general, this implies a higher equity ratio less the extent to which the cash flows from the asset had debt rather than equity characteristics. On this risk-related basis, public sector assets should exceed borrowings associated with those assets – that is, public sector net worth should be positive by an amount which depends on the risk characteristics of the asset portfolio. This criterion would appear to sit comfortably with Buchanan's inter-generational equity approach.

Conclusion

The fiscal policies and government expenditure reforms pursued by the Labour Government reflect vividly the tensions between the desire, and the evident need, for a hard-headed approach to subjecting all government expenditures to a rigorous cost-benefit test and the difficulties of tackling key political constituents.

The Government's approach to fiscal policy during its third and fourth terms of office have reflected the following key features:

- An early determination to reduce the fiscal deficit sharply in a medium-term context by policies which put considerable emphasis on tax reforms to broaden the tax base and to reduce expenditure. In the event, expenditure increases have outweighed the expenditure reductions, imposing a considerable increase in the tax burden facing other sectors.

- A willingness to cut sharply assistance to the agriculture sector (which does not generally support Labour) and much of the manufacturing sector by the application of clearly specified fiscal principles.

- An inability (because of political commitments) to privatise state-owned trading enterprises during the 1984–1987 electoral term. This led the Government to put management resources into commercialising these enterprises – again through clearly specified fiscal principles. (The outright sale of Petrocorp and the 17 December 1987 announcement that one third of the public debt was to be retired by 1992 through asset sales indicate that this constraint is now less binding.)

- A marked willingness to radically reform the administrative activities of government so as to achieve greater accountability, greater clarity of objectives and functions and greater flexibility in pay-setting procedures. However, much yet needs to be done if the old incentive structures are not to reassert themselves.

- Great difficulty in coming to grips effectively with the need to subject social expenditures (health, education, social welfare and housing) to the same rigorous scrutiny as has been applied to other government activities.

By any standards the Government's fiscal policy achievements are remarkable for their medium-term focus, their magnitude and the clarity and coherence of the underlying framework. Nevertheless, in major areas of expenditure, they yet fall short of what is required, and New Zealand still faces major on-going wealth losses from poorly conceived public expenditure programmes. Despite the major efforts summarised in this chapter to raise taxes and reduce expenditure in welfare-enhancing ways, the data indicate that New Zealand still faces major public debt problems involving potentially very large inter-generational transfers.

Notes

General Note

The major statistical documents used when writing this chapter included the following:

Annual Budget Speeches and Annexes, Economic Comentary and Tables, published as Appendix B6 Parts 1 and Part II, respectively, to the Parliamentary Journals for the year in question.

Particularly important references during the 1987 year from these documents include:

- Part I, Annex 1: provides *comparative time series data on various fiscal deficit measures* including inflation-adjusted and cyclically-adjusted deficit measures and a useful discussion of the interpretation of these measures.

- Part I, Annex 2: explicitly quantifies the effects on *net government expenditure trends* of five major policy changes.

- Part I, Annex 3: provides a detailed breakdown of the factors contributing to the 22 percent increase in forecast tax revenue for 1987/88 including, for the first time, much of the underlying information concerning the income distribution and tax parameters driving these forecasts.

- Part II, Economic Commentary: provides useful insights into the rationale for the Government's economic policies.

- Part II, Tables: provides the source data on government debt and expenditure and revenues – on both the traditional "Table 2" parliamentary cash-flow appropriation basis and on the more internationally comparable IMF Government Financial Statistics (GFS) basis.

Estimate Commentary 1987-88, published as Appendix B.7 [Pt. 1A] to the Parliamentary Journals for 1987/88. This document provides, in addition to five-year summaries of expenditure trends by each administrative arm of government, for which parliamentary appropriations are made, a detailed commentary on the newly formed state-owned enterprises (SOEs).

Government Management (Brief to the Incoming Government 1987) Volume I, The Treasury – in particular the section on fiscal trends and fiscal policy, pages 223-238.

Tracking Down the Deficit, Economic Monitoring Group Report No. 8, prepared by David Webber, New Zealand Planning Council (May 1987, pages 1-97).

Interpreting the Fiscal Deficit, Reserve Bank Bulletin (December 1986, pages 497-502).

The Changing Focus on Fiscal Policy, by Graeme Wells, in "Economic Liberalisation in New Zealand" (pages 283-298), edited by Alan Bollard and Robert Buckle (Allen and Unwin, 1987, 364 pages).

Notes

1. See: • New Zealand Treasury, *Economic Management*, Wellington, Government Printer, July 1984, p. 569; • New Zealand Planning Council (NZPC), *Tracking Down the Deficit* (Economic Monitoring Group Report No. 8 prepared by David Webber), May 1987, p. 73.
2. NZPC, op. cit., pp. 78, 87.
3. Ibid. pp. 74, 79, 85.
4. New Zealand Treasury, op. cit., pp. 44, 69.
5. NZPC, op. cit. p. 60.
6. Ibid. p. 85.
7. Ibid. p. 85.
8. *Government Management*. (Brief to the Incoming Government 1987.) Vol: "The Treasury", Wellington, Government Printer, 1987, p. 230.
9. See: *Statement on Taxation and Benefit Reform* 1985. B6B Annex: 20 August 1985, Section 1, p. 23.
10. *Statement on Government Expenditure Reform*. 19 May 1986, p. 9.
11. Ibid.
12. *Evening Post*, 15 April 1988.
13. *New Zealand Yearbook 1987*. Wellington, Government Printer, 1988. p. 345.
14. *National Business Review*, 29 April 1988.

15. *Government Management*, op. cit., p. 226.
16. New Zealand Treasury, op. cit.
17. Buchanan, James. *The Deficit and Our Obligation to Future Generations*. (CIS Policy Report.) April 1987.

Chapter 6

REFORMING THE PUBLIC SECTOR

Roderick S. Deane*

THE IMPORTANT PRINCIPLES UNDERLYING THE economic policy framework which has been developed in New Zealand over the past several years[1] include the need to clarify policy objectives; to pursue these in an appropriately consistent and broadly based manner; to emphasise the medium to longer term perspective rather than being unduly preoccupied with shorter term effects; to provide clear signals to the private sector; to allow markets to work effectively by reducing or removing unnecessary interventions or controls; and to enhance generally the competitiveness and thus the growth potential of the economy. Since government expenditure comprises about 40 percent of GDP, these principles need to apply in an analogous way to the public sector.

The Government sector has, over time, become an increasingly large influence within the economy, encompassing an increasing diversity and complexity of economic activity generally. The traditional public service approach to these changing demands created a variety of problems, including, in a number of cases, a lack of clear objectives and, in particular, the confusion which arose from the mixture of commercial, social, regulatory and policy advisory functions borne by many government agencies. Moreover, even within clearly commercial spheres, there was often a lack of competitively neutral conditions with respect to government organisations which, for example, often enjoyed freedom from taxation and dividend requirements, and invariably operated within a regulatory environment which conferred a range of preferential or monopoly rights.

On the other hand, these organisations also suffered from a number of constraints associated with government ownership and management

*Given the nature of my various positions over recent years — current Chief Executive of the Electricity Corporation of New Zealand Limited; formerly Chairman of the State Services Commission, during the period when much of the public sector restructuring described here took place; and previously Deputy Governor of the Reserve Bank of New Zealand, during the period when the financial and foreign exchange markets were deregulated — it will be self-evident that the views in this chapter are my own.

which distinguished them from their private sector counterparts. (Uniform conditions of employment, based on an occupational class approach to wage setting, is an interesting example of this situation.) The centralised management in the personnel and financial areas, administered by the State Services Commission and the Treasury respectively, aggravated the difficulties.

The lack of clear objectives was associated too frequently with a lack of adequate accountability, resulting from the dispersion of responsibility across the central control agencies, departmental head offices and on-site managers. The problem of defining accountability in a satisfactory manner within the public sector extended also to the relationship between a department's Minister, its head and other senior public servants.

Over time in many government departments, administrative problems emerged in the form of excessive layers of management and undue volumes of adminstrative paperwork. In part, these pressures were induced by the demands of the control agencies and the detailed oversight they maintained of even relatively minor matters. Insufficient attention was given to the potential benefits of decentralised decision-making and flatter management structures. Extensive centralised rules and regulations resulted in too many rigidities and inflexibilities within the public sector.

This accumulation of problems gave rise to difficulties in controlling and monitoring government expenditure and in assessing the value of various functions, as well as a slowness to adapt to change and an inability at times to cope with diversity. In other words, the problems within the public sector reflected in principle many of those which had been identified with respect to the economy generally at the time a new approach to economic management was being developed. These problems included also those of a more fundamental character than administrative and compliance costs, such as poor investment decisions, uncompetitive and non-commercial pricing, resource misallocation associated with inadequate regulatory regimes, and the crowding out of more efficient private sector activity. Public sector reform[3] thus inevitably became an important component in the general programme of economic policy reform.

Revisiting Some Basic Principles

The essential principles underlying the new approach to public sector management included the following elements:

- determination of an appropriate overall framework of relationships, especially those between the Government and state-owned enterprises, and between ministers and head of government departments;

- clarification of objectives, especially between commercial and non-commercial functions;

- enhancement of the adaptability and responsiveness of the public sector to change;

- decentralisation of controls, wider delegations and a wish to encourage managers to manage;

- improved accountability mechanisms and a review of the appropriate mix of incentives and sanctions for public sector managers;

These considerations implied a shift in emphasis from input controls to output assessment within the public sector, and an accompanying need to review the associated organisational issues.

One of the most publicised aspects of this new approach to public sector management was the creation of nine new state-owned enterprises (SOES) in April 1987, and the clarification through the State Owned Enterprise Act 1986 of the principles underlying the operation of both the new and existing SOEs. These principles included the need for SOEs to concentrate upon their commercial objectives; to be run as successful businesses; to be as transparent as possible in their operations by providing full and ongoing information about their activities in a normal commercial manner; to function within competitively neutral environments free of both regulatory favours and inhibitions; to be appropriately monitored to ensure adequate accountability; and, in some cases, to be privatised to ensure the attention of a maximum degree of efficiency.

The Conceptual Framework

In reviewing this process, it may be useful to reflect on the conceptual framework which underpins change of this kind, not only to assist in the examination of the potential success of the SOE corporatisation model but also to help draw any lessons for ways in which this might be enhanced. The applicability of these ideas to the core Public Service departments also warrants consideration. In sketching the framework, it is appropriate to seek some comparison with the private sector model, and the relevance of economic analysis to both the SOE framework and public sector reform more generally.

Recent economic analysis has placed considerable emphasis upon a number of interrelated concepts which warrant an attempt to simplify and summarise. These relate especially to the importance of transactions and agency costs, and the role of property rights.

The first strand of thought is that economic activity is primarily about transactions between different parties; sellers and buyers; firms and customers; lenders and borrowers; individuals and organisations; and owners and managers. At the heart of these interrelationships is the need for information, to facilitate decisions about the transactions which various parties within the economy undertake. The role of the market system is typically to help aggregate and synthesise information and to provide a means of determining these information and transaction costs. Within the marketplace, competition provides a set of incentives to promote good performance and a number of sanctions to penalise inadequate performance by individuals, as well as to assist in the process of discovering what consumers want and what competitors are doing.

The second strand of this analytical framework is the issue of the agency costs incurred by firms which face the problem that the interests of their owners may diverge from those of their managers and other employees. In essence, the company manager acts as an agent for the shareholder, and the owner has to induce the manager to act in the owner's interest. In doing so, certain agency costs are thus incurred.

The third strand of thinking relates to property rights which serve the purposes of ensuring that the people who are most affected by economic decisions are also those who are most efficient at seeking out the information they need and of establishing a set of constraints upon individual actions. Well-defined property rights typically establish the nature of the right of the owner to decide how to use the resource itself and the income from that resource. They also determine the right of the owner to transfer the resource. The usefulness of private property rights in promoting efficient resource use is, of course, influenced by transaction costs. Property rights essentially create incentives to seek out information on the efficient use of resources.

Within private sector corporations, a number of important influences over agency costs help the owner control the management of a firm. These influences include the existence of the stockmarket; the role of skilled investment analysts; the takeover mechanism; the market for managerial services; the role of the board of directors who act under delegated authority for shareholders; the monitoring of company performance by major lenders; competition within the markets for the company's products and services; and, ultimately, the threat of insolvency. These mechanisms are of a mutually reinforcing nature, and information tends to be exchanged by the various participants within this process.

The SOE Model

Relating these concepts to state enterprises brings to attention this problem: public ownership leaves a substantial area of economic activity free from the system of private property rights and may thus impair the mechanisms described above. Within the public sector, SOEs account for around 12 percent of gross domestic product. The need for SOEs to be efficient is thus hardly a matter for debate. The real issue is about how the task should be most appropriately addressed.

For example, when firms are owned by the state, ownership rights are not transferable within the marketplace, and the nature of the owners who are entitled to the income from the assets is more dispersed and less clearly defined because of the generality of the nature of government. The problem with this is that it may reduce the incentives of the owners (the Government) to monitor management performance and to ensure that the resources are being used effectively. The absence of the sharemarket mechanism and the threat of takeover, and probably also the moderation of the threat of insolvency, may make it more difficult to obtain information about the firm's activities and inhibit its ability to resolve problems quickly and efficiently. In other words, because both the owners and the managers of a state-owned enterprise may face less rewarding or less specific incentives and less demanding sanctions than their private sector counterparts, economic performance of SOEs may be impaired. In addition, because of the nature of the political process, the possibility of using state ownership to confer benefits on particular interest groups is probably enhanced in the case of the SOE model.

In summary, the lack of ability to transfer property rights under state ownership and the absence of direct or exclusive rights by individuals to any income accruing from the improved use of the public assets reduce the incentive to control agency contracts and agency costs, may well reduce the incentives for satisfactory economic performance by SOEs, and increase the prospect of political interference in the process.

Alternative ways of addressing these problems are possible, but typically they suffer from comparison with analogous private sector arrangements. For example, monitoring of SOEs could be undertaken by the Treasury or some other government agency, including the use of private sector contractual parties with expertise in this area, but at the end of the day the parties involved are unlikely to have as much incentive or as many pressures upon them to perform the monitoring role as satisfactorily as would the sharemarket and the takeover mechanisms.

In a similar way, in order to ensure that the ultimate threat of bankruptcy exists, the Government may state clearly that no guarantees are provided to SOEs and nor would they be entitled to any other favourable treatment such as subsidies. On the other hand, the mere fact of Government ownership may reassure lenders and other parties involved with SOEs; reassurance which might not be warranted by the economic performance of those SOEs.

As far as the directors and management of SOEs are concerned, the risk of political interference may not only inhibit their potential quality but may also reduce their accountability if normal corporate decisions are overridden in any significant way by political interference.

These problems make it even more imperative than usual for SOEs to operate within competitively neutral market situations. While the present government has endeavoured to reduce to the minimum the subsidies which are granted to SOEs, and has either deregulated or indicated an intention to deregulate the operating environments for SOEs by removing any regulatory privileges, the possibility of these re-emerging through interest group pressure on politicians at some stage in the future should not be unduly discounted. There must be some presumption that these pressures are likely to be generally less effective with respect to private sector companies than they are in the SOE area.

In the legislatively required statements of corporate intent, SOEs have nominated a number of financial and non-financial performance indicators against which their performance can be monitored and accountability assessed. For example, the required rate of return target with respect to investment projects is a useful surrogate mechanism to check on efficient resource use, but while this is analytically readily understandable, there are several technical and practical difficulties associated with the measure and its use.

Problems of this sort, as well as complications in establishing appropriate lines of authority and communications between ministers and boards of SOEs, are well illustrated by the ongoing differences of view which prevailed during 1987/88 with respect to asset valuations for several state enterprises. Indeed, the problems in the asset valuation process, which is something of an artificial one in any event, are appropriate reminders of the difficulties of establishing proxy mechanisms to reproduce the normal role of the marketplace and the private sector negotiating process.

Competitive Neutrality

To some extent, these agency and monitoring problems can be moderated for SOEs by ensuring that they are not given any regulatory protection and that they are not subject to any other particular preferential or subsidy arrangements. Equally, they should not be burdened with any disadvantages which are not shared by their private sector counterparts.

Considerable progress has been made by the Government to deregulate the market environment for a number of state enterprises, by requiring them to pay tax and dividends on a normal commercial basis, by ensuring that they have to fund their own balance sheets on regular commercial terms, by making the absence of a government guarantee explicit and, in some cases, by moving to the sale of shares or equity bonds in the organisations. It is only by moving as close as possible to such a neutral environment that commercial criteria of the normal kind can be used to assess, in a meaningful fashion, SOE performance. This process also ensures that competition for SOEs' products or services will provide both incentives and constraints on their performance.

While this line of reasoning is reasonably clear-cut for organisations such as the Forestry Corporation or Post Bank, which operate in intensely competitive marketplaces where other well-established competitors exist, it has often been argued that the case for state control and ownership is greater in those situations where important monopoly elements are perceived to exist, such as with Telecom and the Electricity Corporation.

However, economists' views on the nature of competition and monopoly have undergone considerable modifications over recent years. Whereas monopolistic behaviour was formerly regarded as a problem in markets where there appeared to be only one or very few producers, and these were seen to have the ability to restrict output and/or increase prices in order to enhance "monopoly profits", economists now tend to take a rather broader and more dynamic view of what constitutes competition.

The forms of competition are seen to be diverse, numerous and generally pervasive with contestability and competition being judged against a much broader perspective than simply the nature of a particular market or the presence of a particular single firm. Monopoly problems are essentially ones of scale and degree.

In New Zealand, the Electricity Corporation (Electricorp) has often been quoted as an example of a natural monopoly. However, there was nothing "natural" about the legislative protection it had in its earlier guises against competition from other power generators or the legislative monopolies existing as a result of the geographic boundaries constraining competition between electricity supply authorities. These "monopolies" were essentially artificial in character.

Closer analysis of the activities of Electricorp makes it clear that other parties could readily get into the power station business; the recent deregulation has indeed indicated there is considerable interest in doing so. Consequently, there should be no constraint on other parties marketing electricity, providing they can utilise the National Grid.

To continue with this illustration: when the process of deregulation of the electricity industry is complete, both the production and marketing ends will become fully contestable and the only natural monopoly to remain will be the National Grid. This is why Electricorp has placed considerable attention upon the need for transparency with respect to the Grid's operation, and has provided explicit assurances with respect to access rights for other parties on the same basis as the Corporation itself.

Setting up the Grid as a separate company, with outside directors and full transparency, should be a more satisfactory alternative than regulatory or rate-of-return controls as a means of constraining any potential monopoly power. This is, in effect, a voluntary form of the common carrier provision which is utilised in a number of overseas countries with respect to similar monopoly networks.

As far as the Production and Marketing Divisions are concerned, not only will there be internal competition within these groups, and between them and other groups such as PowerDesignBuild (the design and construction arm of Electricorp), but it also needs to be borne in mind that the relevant market perspective is that of the total energy market rather than simply the market for electricity. The intrusion of gas and other forms of energy into the market share of electricity over recent years confirms this. The alternative of price or rate of return regulation as a means of controlling a monopoly is a complex one given the major problems faced by regulators in obtaining the information they require to exercise appropriate judgements about either price or rate of return setting.

Historical experience in New Zealand with such controls suggets that bureaucrats are not good at making these types of judgement and do not have the appropriate mix of incentives and sanctions to ensure that they make decisions which are necessarily more satisfactory than those made by the relevant company itself. This, in turn, suggests that the emphasis should be on providing fully contestable market environments and appropriate private sector monitoring arrangements, such as via the sharemarket or the mechanism of the potential takeover, to check the performance of the enterprise.

It needs to be remembered that state control of itself does not prevent an organisation from having the ability to exercise monopoly power; it may even open the way for SOEs to be used to further political ends rather than improve economic efficiency. Actual or perceived monopoly power should thus be constrained not simply by state ownership, which carries with it all the other problems already discussed, but rather by making the operating environment of the SOE organisations as contestable as possible. By taking a broader view of the processes of competition, it can be seen that the problem of "monopolies" is not nearly as pervasive as has sometimes been thought, providing there is a willingness to pursue deregulation in a vigorous and innovative way. Too many so-called monopolies have, in fact, been of an artificial character, buttressed by state ownership itself, legislative protection, trade barriers and other artificial impediments to competition. The key issue is the identification and removal of these impediments. This is not to deny that there may be a residual role for some form of competition authority (of which the Commerce Commission is the present example) to ensure efficient pricing. The trick, of course, is to ensure that such an authority does more good than harm.

***Privatisation*[3]**

This line of analysis suggests that there are three principal stages to the commercialisation of state sector business-type activities. The first involves the conversion of the traditional commercial type government department to a corporation format, while the final stage involves the privatisation of the corporation. Associated with each of these changes is, of course, the need for adapting the regulatory environment within which the enterprise operates to one which is as competitively neutral as possible.

Various reasons have been adduced for privatisation, including improvements in efficiency, assistance with debt reduction, encouraging a spread of share ownership in the economy and moderating the influence of government generally within the economy.

At first sight, it may appear that a significant gain from privatisation is the revenue accruing to the Government from the sale of the assets of the SOE. However, further reflection demonstrates that this gain is illusory. If the sale value of the firm to be privatised is equal to the present value of its expected public ownership profit stream, then the public sector has not altered its net worth through the privatisation process. In other words, the real economic gains are confined to productive efficiency improvements and do not relate to the balance sheet effects accruing from the sale of assets (thus substituting private sector liabilities and assets for public ones). The gains do not accrue simply from the act of transferring ownership from the public to the private sectors, but rather from any improvement to the way in which the assets are used, that is, through efficiency gains, generated by exposing the organisation to the normal disciplines (incentives and constraints) of the marketplace.

The essence of the efficiency gains is that customers should benefit from more favourable prices, as well as from wider choices and better service. Privately owned organisations are likely to be more responsive than their state sector counterparts to changing market conditions and varying customer demands, and to be more innovative when introducing new products and generally adapting to change. The problem of agency costs referred to earlier is likely to be less severe in privately owned organisations than in SOEs because of the existence of improved incentives and stronger sanctions. Sharemarket listing, private sector monitoring, full exposure to private sector product and capital markets, takeover possibilities and other similar considerations underpin this line of reasoning.

In New Zealand, considerable progress has been made in recent times with respect to the first two stages of improving the efficiency of state sector commercial undertakings. Many of the state sector's commercial activities which were formerly run as government departments have now been placed on a more commercial corporate footing, and the market environments within which they operate have been made competitively more neutral. The necessary third stage in this process, that of selling shares in these companies to the private sector to ensure that the ultimate efficiency gains are indeed realised, has been commenced and is likely to become the major thrust of policy over the next year or two.

In economic terms, this process should facilitate a more satisfactory means of determining information and transaction costs, reducing agency costs and ensuring that the private sector system of property rights does its job in promoting the efficient use of the country's resources.

The SOE reforms should be seen as a consistent and integrated package of changes involving commercialisation, corporatisation, deregulation and privatisation. The ultimate effectiveness of the package depends on its completeness, and in this area the major part of the reform yet to come is that of privatisation. The efficiency and profitability gains made by a range of the new SOEs demonstrate the potential contribution of the process to enhancing economic growth for the community generally.

Local Authority Reform

The progress made on SOE reforms illustrates the way in which they could also be applied to substantial elements of local government, including such trading organisations as harbour boards and electric power boards.

For example, given that electricity supply authorities are essentially normal commercial undertakings and so should be required to operate as successful businesses in much the same manner as state-owned enterprises, a package of reforms could be envisaged which would enhance their efficiency and effectiveness. This package would need to include the same elements as those outlined for SOEs: converting the local authority to a normal commercial corporate body; deregulating its operational environment by, for example, removing area franchises; privatising its ownership, for example, through the sale of shares or the giving of shares to local ratepayers or some other appropriate community group; structuring the balance sheets in a normal commercial way with appropriate debt equity ratios; raising new capital via share issues to the private sector; and making the new companies subject to an appropriate regulatory regime with respect to access to their distribution lines (such as by way of the normal Commerce Commission provisions or perhaps some special regulatory provision).

The application of similar principles to local authorities seen to have social as well as economic functions, or to those which are funded in some central manner, such as hospital boards and area health boards, is also possible; indeed, proposals of this sort were made by the Hospital and Related Services Taskforce in their report on New Zealand's hospital system (the Gibbs Report).[4]

This report criticised hospital management for practices similar to those of other public sector organisations, including "triumvirate or consensus management", misuse of staff resources, lack of management information, lack of cost consciousness and lack of productivity monitoring. It also contrasted public sector productivity with the considerably better private sector productivity and argued that, overall, output gains of 30 to 50 percent for the same outlays could be achieved by changing management systems and practices.

The Public Service

The general direction of reform for the commercial arms of central and some areas of local government has now become clear, and although much remains to be done, the basic principles have been well established. Within the remaining Public Service, some further organisations warrant conversion to SOE status, and this is likely to occur over the next year or two.

Once a full separation of commercial functions from the "core" Public Service has been achieved, the principal functions of the Public Service will be those of the more traditional kind: the provision of policy advice, oversight of regulatory functions, maintenance of law and order and provision or support of a range of social services. Some of these activities, such as the protection of borders, relations with other countries, the legal system and a wide range of policy advisory services, can fairly be described as fundamental to the process of government. In addition, there are activities which support the machinery of government and which define the relationships between organisations and individuals in terms of some view of the "collective good". These activities include tax administration, pollution controls and those relating to judicial system.

On the other hand, there are a wide range of services provided substantially by government, either directly or indirectly through funding or subsidies, where delivery is not necessarily the prerogative of government. Social services fall clearly within this category; the health, welfare and education markets are clearly contestable by the private sector, and have been so for many years.

While it could not be claimed that any single "model" of the machinery of government reflects the ideal which should apply to all forms of government activity, there are nonetheless a number of underlying analytical principles which can be drawn from the earlier analysis and which have considerable applicability to the core Public Service, however defined. For instance, there is now a considerable body of evidence to suggest that economic efficiency gains accrue with a progressive reduction of government involvement in the many areas of economic activity that can more efficiently be run by the private sector; that government agencies are typically too numerous and large in size; that there should be separate sources of advice to ministers where conflicts of value may arise; and that a "sector-neutral" system is typically more desirable than the "sector-discriminatory" system where bureaucrats endeavour to assess the gains and losses from various forms of subsidies and incentives for different types of activity.

Any model which accommodates these principles should be concerned with achieving the maximum clarification of objectives, improving the consistency of policy advice and implementation, increasing the transparency of government interventions in terms of both their costs and benefits and achieving cost efficiencies at an operational level.

In each of the areas of concern, whether it be setting objectives, ensuring accountability, or determining such organisational matters as pay scales, top appointment procedures or the role of control agencies, it needs to be remembered that there is a wide range of government activities, from those which are clearly the prerogative of government through those which are contestable by the private sector to those which are clearly most successfully run on private sector lines and should be the prerogative of the marketplace. As far as the core Public Service is concerned, the important issues relate to the definition of those activities which are legitimately and most efficiently performed by central government, and how these should be most appropriately organised to ensure the community gets value for money.

The concept of a public service comprising a wide range of government departments carrying out an increasingly diverse and complex array of economic activities is one which has been severely questioned as the costs of this process have become clearer in recent years. The monitoring functions exercised over the Public Service by a small group of control agencies represented a mechanism which could act as a substitute for the normal private sector monitoring arrangements and reflected the wish to preserve a unified public service with essentially uniform conditions of employment. This approach resulted in a high level of stability for the Public Service, a substantial measure of political neutrality and the avoidance of both patronage and victimisation with respect to individual public servants. High levels of integrity and honesty within the Service were matched by extensive protection mechanisms and security of tenure.

The unified and uniform Service was based on important authorities enjoyed in particular by the Treasury and the State Services Commission, and these had their practical expression in the form of highly centralised and detailed input control mechanisms as encapsulated in the *Treasury Instructions* and the *Public Service Manual*. Tight controls were exercised over of the components and total departmental expenditure, as well as with respect to staff members and personnel policies.

It is not surprising that a variety of serious problems emerged with this traditional approach to the Public Service. Confusion of objectives, lack of accountability, inadequate adaptability to change, over-centralised control mechanisms, multi-layered management structures, excessive paperwork burdens, dispersion of responsibility, widespread internal protective mechanisms and, ultimately, an inability to exert appropriate control over government expenditure to characterise large parts of the public sector.

Deregulating the Public Service

The response to these problems, apart from segregating the commercial functions under the umbrella of the SOE process, has been to decentralise the control mechanisms by much increased delegations from the control agencies (for example, 95 percent of the 2,000 individual instructions in the *Public Service Manual* were delegated to departments during 1986); to review the public sector wage determination process, initially by way of amendment to the State Services Conditions of Employment Act 1977 and more recently by the State Sector Act 1988; and to carry out a fundamental reappraisal of relationships within the Public Service that is, among ministers, heads of departments, control agencies and employers and employees and of the mechanisms for enhancing the adaptability of the Service. This review took the form of the State Services Act 1988, which replaced the State Services Act 1962, the State Services Conditions of Employment Act 1977 and the Health Services Personnel Act 1982; it also had a bearing on the Higher Salaries Commission Act 1977.

The major changes introduced by the new Act[1] relate to appointment procedures for heads of government departments, abolition of the appeal system, creation of a senior executive service, a shift in industrial relations arrangements towards those of the private sector, provision for negotiation of awards and agreements in a manner generally similar to that prevailing in the private sector, consequent abolition of the issuing of determinations, a reduced role for the Higher Salaries Commission and a revised role for the State Services Commission.

Top Appointments

Although important interrelationships exist among the roles of Parliament, the Government, the Cabinet and Caucus, the present accountability mechanisms suggest that ministers are primarily responsible for policy matters while heads of government departments are responsible for administering their departments. Heads also have a role in advising on policy issues and in implementing policy decisions. Since the relationship between a minister and a head provides the principal link between the political and non-political arms of the executive, there is a need to clarify this relationship and the accountability mechanism it implies.

Under the old 1962 State Sector Act (Section 29), an augmented Commission (the chairperson, a Commissioner and three other permanent heads chosen from a panel of twelve) were able to appoint all heads of departments and other senior managers at deputy level and some assistant head levels. The panel had the power to consult whomever it wished; ministers had no formal role in these proceedings. This arrangement contrasted with that recommended by the Royal Commission which preceded the passing of the 1962 Act. The Commission had recommended that the State Services Commission would make recommendations with respect to the appointment of heads, but that the Prime Minister would have power to reject the nomination and make a personal appointment. It was envisaged that the Commission's recommendation would normally be accepted and, if overridden, this would be made public. The Royal Commission's recommendation acknowledged the ultimate responsibility of the departments' ministers and the Government but, in the event, the Government of the day decided to leave matters to the State Services Commission.

Under the 1988 Act, the previous implicit principal/agent relationship between ministers and heads of their departments is explicitly provided for in that ministerial decisions on the appointment, remuneration and removal of heads (now called Chief Executives) will be exercised by either the Governor General in Council (in effect the Cabinet) or, in some cases, the Prime Minister and the Minister of State Services.

Chief Executives will be appointed on the recommendation of the State Services Commission although, if a recommended person is not acceptable to the Cabinet, it may make its own choice, with this fact then needing to be made public. Chief Executives will be appointed on individual contracts; whoever is appointed will need to meet the legislative provision that the chief executive can discharge the specific responsibilities placed on the position and achieve the various objectives applying to the department in question.

Chief executives will be responsible to the appropriate minister for the carrying out of the functions and duties of the department, tendering of advice to ministers, the general conduct of departments and the efficient, effective and economical management of the activities of the department. The Higher Salaries Commission is no longer involved in the process of setting remuneration for Chief Executives. The State Services Commission will be responsible for reviewing the Chief Executives' discharge of their functions, and their performance, relative to their objectives. This process should thus be considerably more explicit than it has been in the past.

While some concern has been expressed about the possibility of "political" appointments being made under this new system, it could be argued that it strikes a reasonable balance between the need for professional selection procedures (the involvement of the State Services Commission) and an appropriate representation of the principal/agent relationship which is implicit in the minister/chief executive relationship. Appointment solely by a third party, as it was under the 1962 Act, raises serious concerns about accountability and responsibility in terms of these relationships. It is worth bearing in mind that the new arrangement is still a relatively constrained one when compared with a number of other countries such as the United Kingdom, Canada and Australia whether either the Prime Minister or the Cabinet has unencumbered decision-making powers with respect to departmental heads. At least in the New Zealand environment, the State Services Commission has an explicit role in recommending appointments, and if a recommendation is overriden then the Government must indicate this publicly.

Industrial Relations Arrangements

The original intention in designing the new State Services Act 1988 was to apply to the state sector most of the provisions of the Labour Relations Act 1987, which governs industrial relations in the private sector. This intention implied, for example, that minimum conditions of employment rather than determinations would be set out in industrial agreements; that the terms of those agreements could only be changed by agreement between the negotiating parties; that there would be no automatic right for state unions to take claims to arbitration; that, as in the private sector, arbitration would only be possible if both parties agreed to this (but with special arrangements continuing to apply in the case of the Police and the Armed Forces); and that the arrangements for changes to be made to union coverage and the limitations on the minimum size of unions which already apply to the private sector (a minimum of 1,000 members) would also apply to the state.

A major special provision which has been retained in the state sector is the "good employer" requirement. This provides explicitly for recognition of the needs of Maori people in the Public Service, acknowledgement of other cultural, ethnic and minority group interests and recognition of the employment requirements of women and people with disabilities. All departments are required to have an equal employment opportunities programme and to report regularly on progress under this.

Although the original draft of the Act included a statement setting out the objectives to be followed in determining pay and conditions of employment within the Public Service, these criteria were removed before the Act was finalised. Moreover, the final Act provides for awards as well as agreements to be negotiated for state employees, and an option under which a state union and the state employer concerned may agree to forego their rights to strike or lockout in relation to disputes of interest and agree instead that matters remaining in dispute should be resolved by "final offer" arbitration. The Act provided for a carryover of all existing terms and conditions of employment, other than where a specific exception was provided for, as in the case of the abolition of the appeal system. As far as appointments are concerned, there is a requirement in the Act for preference to be given to the person who is best suited to the position. Appointments under this arrangement, and transfers, can now only be challenged on the basis of the same common law rights as prevail in the private sector.

As for the health service, including area health boards and hospital boards, the provisions of the Act virtually repeat those which apply to the Public Service but with the necessary changes to reflect the role of the board concerned, and the Minister of Health.

The role of the State Services Commission is substantially altered in the sense that chief executives will become the employing authorities for their departments whereas previously the Commission was the employer for the whole of the Public Service. However, the Commission will continue to be the negotiating agent for conditions of employment in the Public Service, with a requirement to consult with the Chief Executives of departments.

The Commission will have an important role in recommending appointments of chief executives; overseeing the new senior executive service, which is designed to provide and maintain a group of up to 500 senior employees with the ability and training to manage public service departments at a senior level; offering policy advice to the Government on public sector issues; monitoring the activities of departments; and promoting new initiatives in such areas as equal employment opportunities, the deployment of surplus staff, occupational health and welfare, grievance handling, and personnel policies generally. Along with this administrative oversight, the most important functions for the Commission will probably concern top level appointments, policy advice on Public Service issues, and as an "agent for change" in terms of assisting the Government to achieve any changes it seeks with respect to government departments.

The new Act has sensibly clarified the relationship between a minister and the head of a department, and has, in effect, provided the minister with a professional body able to advise on the appointment of Chief Executives. It has also, in the form of the State Services Commission, provided a means of reviewing chief executives' performance. These provisions acknowledge the usefulness of a third party in assisting ministers to monitor departments not subject to normal private sector performance assessment mechanisms. There remains a curious dichotomy between the departmental head and that person's ability to control departmental expenditure in the sense that the State Services Commission is the compulsory negotiating agent on conditions of employment. The real question is whether the statutory requirement for the Commission to consult with the chief executive will provide the latter with sufficient flexibility and control to ensure full accountability for his or her management of the department, or whether something of the old dispersion of responsibility among the ministers, the control agencies and the departmental head will prevail. Although the new Act represents a substantial amount of effective delegation to departmental heads, certain doubts presumably linger about the ability of chief executives to manage their own industrial relations independent of the Government (in the form of its representative, the State Services Commission).

As far as wage fixing is concerned, the new Act should facilitate a more flexible and adaptable system within the Public Service. Just prior to the introduction of the Bill, the Government reached agreement with the Public Service Association to introduce what will amount to the old collective occupational class agreements which applied across the board in the Public Service.

Moreover, the removal of specific criteria for determining wages and the application of private sector institutional arrangements to the Public Service should help ease the previous excessive concentration upon relativity comparisons and provide, ultimately, for settlements better suited to the particular needs of individual departments. As time goes by, flexibility should also be enhanced by the removal of the constraints imposed by the Higher Salaries Commission, much of the old centralised co-ordination arrangements within the public sector and the emphasis on such matters as national rates and the automatic entitlement to an annual general adjustment based on a set formula. This entitlement was, in fact, removed in earlier legislation, and provision for such matters as performance pay and ranges of remuneration is now possible.

While the new legislation offers the promise of more flexibility, it remains to be seen to what extent it achieves, in practice, an appropriate mix of decentralised management and improved accountability. The essence of the matter, as always, is to decide clearly what functions the Government wishes to perform, how much it is prepared to pay for them and how it should improve the mix of incentives and sanctions used to ensure that public service managers carry out these functions efficiently and effectively.

In any reform process, the ideal is to retain the most desirable values of the past while simultaneously providing sufficient adaptability for both foreseen and unforeseen future requirements. It may appear easy to point to desirable new directions, but achieving the appropriate balance between the various elements in practice is not.

Moreover, although it is known that a considerable body of work has been carried out to develop a framework of thinking within which further changes can be made to the machinery of government – for example, changes concerning the ministries which still remain after the establishment of state-owned enterprises – this framework has been subject neither to widespread public discussion nor to an apparent commitment from the Government. The development of such a framework, and appropriate criteria for further "machinery-of-government" changes, including whether these should be on a sectoral or a functional basis, is probably the major area still needed to be addressed in the Public Service reform process. In addition, a review of the Public Finance Act 1977 is no doubt warranted in order to ensure that changes in the control functions exercised by the Treasury complement the new arrangements which now apply in the personnel areas.

The scale of the actual changes which have occurred within the Public Sector, and in particular the Public Service, should not be underestimated. For example,[7] during the financial year 1986/87, this process affected 25 percent of the staff (including an estimate for wage workers) of the former Public Service by removing 11 percent into a corporate commercial environment (state-owned enterprises), shifting 8 percent into new departmental organisations and reducing total staff numbers by a further 6 percent as a result of voluntary severance, early retirement and other options under the deployment package. Despite widespread media assertions to the contrary, no public servant was made compulsorily redundant by this process. The voluntary options were successful in bringing about a major, albeit at times difficult, transition.

If wage workers are excluded because of the difficulties of estimating their number, the total number of permanent staff and temporary staff in the Public Service on 31 March 1987, immediately prior to corporatisation of the nine SOEs on 1 April 1987, was 72,417. By 31 December 1987, this number had declined to 59,931, a fall of 17.2 percent. This figure is essentially made up of those who went to the SOEs and those who left the Public Service for various reasons, including severance and early retirement.

It should also be noted that, apart from those SOEs which achieved staff reductions at the time of the switchover from departmental to corporate status, SOEs since their establishment on 1 April 1987 achieved significant staff savings. For example, in its first year of operation, the Electricity Corporation, which is the largest SOE in terms of asset value, reduced overall staff numbers by just over 20 percent. Some of the other corporations made staff savings of even greater magnitude than this, as in the case of the Forestry Corporation, which now operates with about one-third of the number of staff it formerly had under its old departmental format, and the Coal Corporation, which now operates with about one-half of the staff it formerly had, although, interestingly enough, its total production of coal is still much the same as before. It is clear that the corporatisation process has achieved very substantial productivity gains in a wide range of areas.

Conclusion

The changes which have taken place in the public sector have been designed to clarify relationships and objectives, to improve accountability and decentralised decision-making and to match objectives and resources more efficiently and more effectively than in the past. The means of doing this have been to decentralise authority through widespread delegations, either directly or by legislative change, from the central control agencies to individual government departments, and to match these changes with increased responsibility for individual managers. Within the commercial sphere of government activity, corporatisation and privatisation are seen as the vehicles for facilitating the process of change. Industrial relations arrangements have been significantly liberalised and are now similar in many respects to those prevailing in the private sector. However, this is not to say that further progress cannot be made in this area, particularly since more flexibility is really needed with respect to such matters as freeing up national award arrangements, reverting to voluntary unionism and removing the minimum number requirement for union membership.

For the public sector, the aim of these changes has been to improve adaptability and to reduce the old rigidities and inflexibilities. The principal legislative vehicles for change have been the State Owned Enterprises Act 1986 and the State Sector Act 1988. The old State

Services Conditions of Employment Act 1977 has now been superceded, and the role of the Higher Salaries Commission Act 1977 has been much reduced.

Substantial progress has clearly been made not only in deregulating the public sector, and thus enhancing its prospects of becoming more efficient, but also in reducing its size. However, further changes are still required to round off the package of reforms already undertaken. The principal areas warranting further attention include local authority reform, particularly with respect to local authority commercial undertakings; a review of the Public Finance Act 1977; further liberalisation of the private sector industrial relations regime, since this now has importance for the public sector; further deregulation of the operating environments of a range of state-owned enterprises and government departments; and the development and publication of a comprehensive framework for any further machinery-of-government changes within the core Public Service to ensure that these are carried out in a consistent and integrated fashion.

The changes which have occurred, and those which either will occur or may be addressed in the future, unquestionably open up the way for a more efficient public sector. And greater efficiency – implied productivity – not only will contribute positively to a more satisfactory economic growth performance for the country as a whole, but also must ultimately benefit public sector employees and the environment in which they work.

Notes

1. A general background to the changes in economic policy is provided by: •Deane, R. S., The New Zealand experience, *in* John Hyde and Michael Porter (eds.), *The Good Fight*, Australian Festschrift in Honour of Austin Holmes, in press; •Douglas, Roger & Callan, Louise, *Towards Prosperity: people and politics in the 1980s*, Auckland, David Bateman, 1987; •James, Colin, *The Quiet Revolution: turbulence and transition in contemporary New Zealand*, Wellington, Allen and Unwin/Port Nicholson Press, 1986.

   The economic situation prevailing prior to the Labour Government coming to power in 1984 is summarised in: •The Treasury, *Economic Management*, Wellington, Government Printer, July 1984; •*A Briefing on the New Zealand Economy*, Economic Summit Conference, Wellington, 1984.
2. For other reviews of the issues involved with public sector reform, see: •Clark, Margaret & Sinclair, Elizabeth (eds.), *Purposes, Performance and Profit: redefining the public sector*, New Zealand Institute of Public Administration, proceedings of 1986 conference; •Deane, R. S., *Public Sector Reform: a review of the issues*, in Margaret Clark and Elizabeth Sinclair, op. cit., and in abbreviated form in Management Leaflet No. 15, State Services Commission, Wellington, November 1986; •Douglas, R. O., *Budget 1987*, Wellington, Government Printer, 1987; •McKinlay, Peter, *Corporatisation: the solution for state owned enterprises?*

Wellington, Institute of Policy Studies, 1987; •Roberts, John, *Politicians, Public Servants and Public Enterprise: restructuring the New Zealand Government Executive*, Wellington, Institute of Policy Studies, Victoria University of Wellington, 1987.

Some of the actual gains from the process of reform are set out in dramatic terms in Douglas, R. O., op. cit.

3. The early policy commitment to privatisation was confirmed by the Minister of Finance in Douglas, R. O., op. cit. and in Douglas, R. O., "R. N Spann Memorial Oration", Royal Australian Institute of Public Administration, the Refectory, Sydney University, Sydney, 27 October 1987.

   Some of the issues are well set out by Jones, G. W. *Privatisation: reflections on the British Experience*, Wellington, Institute of Policy Studies, 1987.

4. See: Hospital and Related Services Taskforce. *Unshackling the Hospitals* (The Gibbs Report), Wellington, Government Printing Office, 1988.

5. See: •State Services Commission, *State Sector Bill*, Service, Vol. 1, No. 1, Wellington, February/March 1988; •State Services Commission, State Sector Bill Update, Issue 3, Wellington, 16 March 1988.

6. The Government's position on the labour market changes is set out by Stan Rodger, Minister of Labour and Minister of State Services in: •Rodger, Stan, *Government Policy Statement on Labour Relations*, Wellington, Government Printer, 1986;• Rodger, Stan, *Pay Fixing in the State Sector*, Wellington, Government Printer, 1986.

   A contrasting view is provided by the New Zealand Business Roundtable in: New Zealand Business Roundtable. *New Zealand Labour Market Reform: a submission in response to the green paper on industrial relations*, Wellington, April 1986.

7. These figures exclude the Post Office, which comprised almost 40,000 employees who were split into three new corporations on 1 April 1987.

Chapter 7

TAXATION

Ian Dickson

IN CONTRAST TO THE GENERAL deregulation of the New Zealand economy which has occurred since the election of the Labour Government in July 1984, taxation reform has become increasingly complex and has led to more detailed reporting of financial affairs to the tax authorities by a larger number, and wider spread, of individuals and businesses. This chapter traces major changes which have occurred in the New Zealand tax system. It looks at the motivation for the policies and places them in a contextual framework.

Taxes in New Zealand Prior to 1984

In the early part of this century, New Zealand established its tax system along classic British lines. Historically, the major revenue source was customs duties and excises. From the 1950s, progressive income taxes assumed a greater significance as a source of government revenues. The pattern of taxation developed as follows:

- Nominal income tax levied at progressive rates, along with "double" taxation of dividends and a wide array of concessions. These conferred a partial expenditure tax treatment on classes of assets (for example, superannuation funds) or businesses (for example, farming). Taxation of capital gains was generally excluded.

- An array of excise duties and selective sales taxes on traditional excise goods: alcoholic beverages, tobacco products, petroleum fuels, motor vehicles and certain services.

- Tariff-based customs duties on imports.

- Estate and gift duties, stamp duties, a land tax and devolved local government taxes based on real property values.

- A range of resource "rental", user charges and *ad hoc* minor taxes.

Minimal change to this pattern occurred after the 1950s, and little development of the tax system took place to keep abreast of commercial and economic developments.

Administration of taxes during this period would be judged average by the standards of developed countries. Little use was made of emerging computer technology for active policing of the tax system, and enforcement methods tended to be passive. It must be acknowledged, however, that the tax system was not, at that time, an intrinsically difficult one to administer. Many of the difficult administrative judgements had been removed by concessions. For example, timing issues about the accrual of depreciation on plant and machinery were largely irrelevant when accelerated depreciation combined with an investment allowance allowed a first year write-off of 60 percent. Moreoever, in a general business environment which involved quite detailed regulatory controls and required official consents for many new ventures (for example, to import machinery or buy foreign exchange), it was relatively easy to piggyback tax provisions on other regulations.

The drawbacks of the New Zealand tax system became increasingly apparent in the inflationary conditions which prevailed towards the end of the 1970s. An increasing demand for revenue was prompted by rising government expenditure and stagnating economic activity. Industrial subsidies, unfunded age entitlements and unemployment compensation, and a growing base-load of debt service and general departmental expenditure were the sources of extra revenue demands.

The narrow base of the tax system in New Zealand, and a political unwillingness to reverse the erosion of the tax base except in minor extension of indirect taxes, led to a rapid escalation of average income tax rates over the latter part of the 1970s and early 1980s.

Much of the increasing tax revenue was achieved by failure to fully or fairly index the progressive marginal rate scale. The result was that middle and upper income average tax rates rose rapidly, increasing the nominal progressivity of the personal tax scale. Simultaneously, a combination of falling business profitability and increasing tax concessions (especially for exporters) meant that businesses tax revenue remained static in nominal terms.

The 1982 Taskforce on Tax Reform (the McCaw Committee), highlighted the general deficiencies in the New Zealand tax system. It drew attention to the popular dissatisfaction with tax rates and an increasing resistance to higher taxes. That resistance manifested itself in a proliferation of fringe benefits for high marginal rate individuals and tax-based investment schemes. The McCaw Committee's solution was to shift more of the tax burden on to consumption expenditure, adopt a generally less progressive scale of marginal tax rates and carry out overdue repairs and maintenance on business tax provisions.

Little of the report was implemented at the time. The exception was the introduction of a generally less progressive marginal tax rate scale, which resulted in a substantial unfunded reduction in revenue. The giveaway side of the reform package introduced in October 1962 reduced government revenue by over $1,000 million in a full year and contributed to cementing in the low wage path achieved under the 1982/84 wage and price freeze. However, it began a fiscal blowout which pushed the financial deficit to 7 percent of GDP in 1983/84 despite general restraint in government costs from the wage and price freeze.

The tax system in 1984 was in a bad state of repair. By and large it was failing to meet the fundamental objectives of raising revenue fairly, cheaply and without distorting economic activity. It is difficult to judge the degree to which tax issues influenced voters in the 1984 election. Certainly, concern over tax issues - particularly an anti-avoidance measure introduced in 1982 to confine tax losses from farm tax concessions to owner operators - was a strong motivation for many people, who shifted their allegiance from the governing National Party to the fledgeling New Zealand Party.

At a technical level, it is clear that the direct tax system was deteriorating into a payroll tax rather than an income tax. Meanwhile, the indirect tax system, based largely on a wholesale-level sales tax and customs and excise duties, was also unable to keep pace with the demand for revenue in an inflationary environment. Thus, at the change of government, there existed an unstable and potentially volatile situation concerning the sources of revenue to fund state spending.

Tax Reform Under Labour

Few parts of the pre-1984 tax system have been left untouched by the Labour Government. Reform was so extensive during the Government's term, and in the first year of its second term, that many people have difficulty remembering what has been done, let alone establishing a framework for assessing the direction of reform - especially with some of the later, more technical, measures. A chronology of tax policy measure since July 1984 is contained in the appendix to this book.

Broadly, four principles have guided the tax reform process since the change of government. These are:

1) Lower marginal tax rates to improve economic incentives, minimise tax-sourced economic distortions and improve decision-making.

2) Coupled with the move to lower marginal rates, a broadening of the tax base by including a larger proportion of the target

economic aggregates (income or consumption) in the tax net, and (more controversially) adopting measurement principles which more closely resemble theoretical economic apporoaches.

3) The concern that certain low income groups be broadly protected from the immediate effects of tax changes, and that they share in the better overall regime through the elimination of tax-created and income-maintenance-sourced poverty traps. (The target group has generally been confined to low income families, with little attention being given to low income individuals who do not have dependants.)

4) Improved administration through new collection mechanisms, approaches to policy development and legislation, altered balance of proof, new disclosure requirements, increased penalties and changed work practices on the part of tax authorities.

Within this framework, the tax measures have tended to fall into two categories:

Strategic: The reforms, introduced on 1 October 1986, which included a much flattened personal income tax scale, family support tax credits, goods and services tax (GST) and the abolition of existing sales taxes, offer the best example of this type of tax reform. The aborted scheme to introduce a flat tax scale and guaranteed minimum income announced in December 1987 and the adoption of a dividend imputation are further examples. In general, then, reforms classified as strategic are those which are motivated by, and identified with, the above principles of a flatter-rated, broader-based tax system.

Opportunist: In conjunction with the broader reforms, the Labour Government has also undertaken a number of measures to block loopholes, raise revenue and change specific parts of the tax system which are, in important respects, at variance with those basic principles. Examples include the Fringe Benefit Tax, the 1986 Budget increase in tobacco excise and recent changes to the tax collection system for provisional taxpayers. The classification as opportunist is made because, from a public policy perspective, the measures appear to have neither a plan nor the attainment of a stated goal to determine the subject selected for attention.

Strategic Policy Initiatives

The *major* policy initiatives aimed at making a broad-based, low rate tax system, developed consistently over a period of time, have been:

- The 1 October 1986 measures to introduce GST, repeal former sales taxes, lower personal tax rates and increase fiscal assistance to low income families with children.
- The introduction of a full imputation system of company/shareholder taxation.
- Abolition of export incentives, accelerated depreciation and investment allowances, stock valuation procedures and other concessions.
- Reform of the tax provisions affecting life insurance and private superannuation arrangements.

October 1986 Measures

On 1 October 1986 (the mid-point of the New Zealand financial year), the Government introduced the following measures:

- personal income tax rates to be cut on average by 20 percent;
- a family support scheme giving abating tax credits to low income families with dependent children;
- introduction of a broadly based 10 percent value-added tax – the Goods and Services Tax (GST); and
- abolition of former sales tax on general goods (other than motor vehicles where part of the previous sales tax was retained and phased down).

This package of measures had its origins in the first Budget delivered by the Labour Government in November 1984. The centrepiece of the reforms was the introduction of the comprehensive, uniform value-added tax called Goods and Services Tax (GST).

Surprisingly, there was little public opposition to this tax, and very little from the business community. This contrasted with Australia, where a similar proposal foundered on public, union and business opposition. In the months leading up to the introduction of GST, public opinion polls recorded an astounding 40 percent support for it. There are two principal reasons for this.

First, GST was widely regarded, certainly by the business community and by a significant number of taxpaying individuals, as a relief measure. GST would provide relief from the 48 percent marginal tax rate for about average wages and the maximum rate of 66 percent. After the McCaw Committee in 1982, there had been meetings amongst business leaders to generate support for the introduction of a value-added tax. Many in business, for example, saw a value-added tax as a means of improving New Zealand's economic performance by subsidising exports in a way which would not infringe upon the General Agreement on Tarrifs and Trade (GATT) export subsidy rules. The reasons for this would not stand up to economic analysis, but the view itself had a following. Moreover, for a small number of businesses supplying about one-third of final consumption expenditure, it would relieve them of administering the outdated wholesale-level sales tax.

Secondly, the process of developing the tax – preparation of the legislation and public education – was undertaken in a very public way, with leading businesspeople and private sector tax experts assisting. The Government had recently concluded a successful economic summit to gain consensus and approval for its economic reform plans. GST provided a first opportunity to test the Government's resolve, and it was demonstrating a commitment to consult, listen to criticisms and modify its plans (even to the extent of delaying implementation by six months) so that all legitimate complaints could be attended to and taxpayers could have the maximum opportunity to prepare themselves.

The process was in complete contrast to the style of the previous Government, where legislation frequently emerged and was passed on the night of the announcement with little or no public or Parliamentary scrutiny. Certainly, few people went away from the GST consultative process complaining that they had not been given a fair hearing, even if their proposal was rejected.

In effect, the process put into private sector hands much of the detailed work necessary to develop GST. While privatisation of enterprises has become common overseas, privatisation of something so intimately governmental as tax policy is rare. Yet it is this factor, more than anything else, which underwrote the eventual success of GST and ensured that the tax base remained intact and free of non-adminstrative concessions when it was introduced.

GST brought into the tax system 300,000 enterprises, many of which had not previously been in the Inland Revenue Department's register as an employer or taxpayer. It was a massive undertaking in bringing a small-value (in terms of potential tax to be collected) but widely dispersed segment of the private sector within the taxation environment. It also represented a quantum leap in the amount of detailed economic information extracted by compulsion and available to the authorities for analysis and use in governing the day-to-day affairs of enterprises.

Full Imputation

The proposal to introduce a full imputation scheme was first announced in the 1985 Tax and Benefit Reform Statement.[3] The objective was to remove the double taxation of dividends while providing a withholding mechanism which would ensure that dividends would be taxed at the shareholder marginal tax rate.

The rationale for adopting full imputation was to end the distortions created by double taxation of dividends under the classical company/shareholder relationship. These distortions were described as:

- An incentive for companies to retain earnings with the effect of locking capital into potentially less efficient activities, or making "cashed-up" companies targets for takeover and asset stripping.

- An encouragement of debt financing at the expense of equity investment.

- Imposition of excessive taxation on individuals deriving income through different means.

In general, then, the rationale was clearly identified as a desire to remove tax-induced economic distortions, to increase capital mobility and to remove artificial incentives for corporate takeover. A subsidiary, although important objective, was to reduce the incentive for creating capital profits for tax-free distribution to shareholders as a means of tax avoidance.

An interesting feature of the imputation scheme was the intention to discriminate against non-resident shareholders in New Zealand companies and resident investors in non-resident companies, by maintaining the classical system in respect of the dividends received by them. The arguments advanced for this approach centre on standard capital import and capital export neutrality. However, while the simple models which support this approach have an intellectual simplicity and elegance, they do not adequately represent the nature of international capital movements and the effects which tax provisions have on them.

There had, in fact, been a period of debate, particularly within the accounting profession, over the merits of having a dividend exemption scheme instead of imputation. Imputation ascribes to shareholders a share of the tax paid by the company, which the shareholder may then credit against other liabilities. It thus requires a "grossing-up" and apportionment of tax paid by the company in relation to the class of dividends payable. Account needs to be taken of foreign dividends received by a company for which no imputation credit is available, and for allowing a flow-through of credits for inter-company dividends. Dividend exemption, on the other hand, simply makes all dividends received free of tax in the hands of the shareholder.

Dividend exemption, although simpler than imputation, is not as precise in setting the effective dividend tax rate at the shareholder's marginal rate, unless there is a uniform single rate of tax. The other argument against it is that it infringes capital import neutrality for non-resident shareholders.

The imputation scheme eventually proposed was released in a consultative document on 17 December 1987. Submissions were reviewed by a committee of private sector tax consultants, who reported amendments back to the Government. Full imputation took effect on 1 October 1988.

Abolition of Business Tax Concessions

At the change of government in 1984, several sectors in the New Zealand economy were receiving government assistance from concessionary taxation provisions or regimes. These had been introduced over the years and modified from time to time to achieve different objectives. By international standards there was nothing unusual about the features of the concessions - most are found to this day in the tax systems of major economies - but the scale and variety of the New Zealand concessions, and the impact they had on asset prices and returns from investment in assisted industries in an inflationary and high marginal tax rate environment, were unusual.

Perhaps the largest single set of measures was the incentives provided to manufacturers and exporters of non-traditional exports of goods and services. Other significant measures were deductions for capital costs (investment allowances, farm development, mining and petroleum exploration and development expenditure) and accelerated deductions or deferral of income (accelerated depreciation, standard values for livestock). In broad terms, the intention of these schemes was to compensate exporters for domestic costs arising from assistance to manufacturing, to encourage exporting and capital investment, to simplify accounting and to lower the otherwise high tax rates which businesses would face if they paid the full statutory rate.

The effects of these schemes varied. While there is some evidence, mostly anecdotal, that the export incentives had an effect on the perceived attractiveness of broadening a marketing base, the effectiveness of the others must be in doubt. What is clear is that concessions were, to a large degree, capitalised into asset prices - the demand for tax shelter, by converting deductible interest expense into tax-free capital gain through the use of a tax-subsidised investment in an asset in short supply, drives up market prices beyond the point where employment of the asset can give an economic return.

Capitalisation produces benefits for people who are early entrants to assisted sectors and who thus own assets at pre-concession prices and who then sell out. For subsequent entrants, the use of assets produces low returns and the risk of a capital loss should the tax environment change. This is what happened when concessions were withdrawn. Land and livestock values fell, the value of fishing boats, plant and machinery and horticultural land was lowered, and excess capacity and low returns in previously profitable activities were revealed.

These outcomes provided significant evidence to support the Government's assertion that concessions had been diverting resources from productive uses into uneconomic levels of activity in the assisted sector. In hindsight, the degree of distortion had actually been increased by the absence of provisions requiring appreciating asset values to be written back as income, and by allowing full deductions for interest costs which included a significant premium, reflecting the high inflation level. Nevertheless, removing these concessions was certainly appropriate to the stated objectives of the tax reform programme.

The removal of concessions is on-going, with recent developments affecting petroleum mining, and there are indications that mineral mining, property development and ordinary depreciation rates will be reviewed.

Life Insurance and Superannuation

The attack on tax concessions for life insurance and superannuation by the Labour Government began in the 1984 Budget, delivered in November of that year. Life insurance and superannuation concessions, although limited by dollar deductible amounts, were the most costly personal tax concessions. Moreover, in an income tax system, allowing deductions for contributions and exemption fund income, while at the same time taxing arising benefits, give an expenditure tax treatment to this class of savings.

The Government's motivation for winding down these concessions was thus consistent with its overall tax policy thrust of broadening the tax base while lowering marginal rates. The evidence on contribution patterns available to the Government showed a skewed pattern of contribution in favour of relatively high income contributors. Thus, it was argued that concessions tended to favour higher income taxpayers at the expense of those on lower incomes.

Another consideration focussed on the regulatory environment around superannuation schemes. In order to confine the cost of superannuation schemes, a regulatory regime had been developed. For example, various schemes had been categorised and taxed differently, depending of the form of benefits or the contribution. Removing the different tax treatment would also remove the rationale for many of the existing regulations.

The arguments used by the superannuation industry to defend the concessions tended to be based outside the taxation sphere. Typically, the industry argued that without incentives for long-term contractual savings, the savings rate in the New Zealand economy would drop to a degree detrimental to its long-term investment performance. (Note, however, that personal and employer contributions had always been limited in dollars, a limit which had declined significantly in real terms, so the main value of the concession was in exempting fund income - that is, allowing the full pre-tax income to compound.)

To the Government, this argument lacked plausibility, since it saw a better overall climate for savers arising from its policies, notably the liberalisation of financial markets, a reduction in the fiscal deficit, the encouragement for interest rates to find market levels, a lowered inflation rate, a reduction in personal marginal tax rates, a switch from income to consumption tax and the removal of double taxation of dividend income.

The 1984 changes had only a limited effect, and the use of superannuation as a personal tax shelter soon resumed. Similarly, the loss of deductibility for life insurance applied only to those contracts written after Budget night. This did not prevent endorsement of existing contracts to allow continuance of deductibility for higher valued policies. Moreover, the 33 percent rate applied to the investment income of life insurance companies was below the top personal tax rate of 48 percent, giving a tax wedge which was exploited through insurance-based investment.

The life insurance and superannuation industry had, in the past, strongly resisted changes to the regime. In 1982, it initiated a letter campaign against changes to be made by the Muldoon Government. The same public relations machine went to work on the Labour Government, and was clearly in evidence during the 1985 Timaru by-election in 1985 when Labour lost a safe seat. But the industry's campaign only hardened the Government's attitudes towards it and its case for continuance of concessions.

The superannuation industry was not touched again until after the 1987 General Election. The 17 December Economic Statement[3] had proposed the complete abandonment of concessions for superannuation, to take effect on a fast, although generous to past contributors, basis. A consultative committee would be employed to study submissions. However, as in previous cases, its terms of reference would not allow it to examine, to any great degree, the basic policy issue.

During this time, the industry held out hope that the Government would change its mind and allow a continuance of concessions for pension superannuation. Eventually, the consultative committee did report on an alternative to the Government's proposed regime, an alternative which reversed the tax position of contributions and benefits by making contributions tax free. This was not accepted.

When, however, tax concessions for life insurance and superannuation are looked at in the context of the Government's broad thrust of tax policy, and within the measures taken to liberalise the financial sector, a thread of consistent decision-making is apparent. However, the abolition had a severe impact on funds under management at a time when cash flow was under pressure due to widespread redundancy, and the aftermath of the October 1987 sharemarket fall. With hindsight, it is apparent that too little attention was paid to the wider policy implications of abolishing these concessions. A more considered approach with a longer transition might have avoided the difficult adjustment which occured and its effects on the climate of confidence in the economy generally.

Opportunist Policy Initiatives

Perhaps more interesting than the strategic measures from regulatory viewpoint are some of the opportunist measures. Although less noteworthy in terms of grand scale and design, many of these measures have had important effects – not always positive – on New Zealand's business environment and pattern of economic activity. Understanding of the thrust and direction of policy advice in this area is important, as it will enable taxpayers to predict and adapt to new developments.

In some respects, opportunist tax policy initiatives have been aimed at undoing, for tax purposes, general economic liberalisations. The apparent contradiction has not escaped taxpayers and is confusing to many. Moreover, the complexity of significant measures, and the number of seemingly independent and unco-ordinated changes, has altered taxpayers' previously receptive attitude to reform on a grand scale.

While executing an overall design for reforming the tax system, the Labour Government has nonetheless shown itself willing to take shortcuts and introduce measures, most notably the following, which are not fully consistent with its broad policy thrust.

Fringe Benefit Tax

The Fringe Benefit Tax (FBT) was one of the first initiatives introduced by the Labour Government. In contrast to the standard tax principle of taxing the value of income, whether cash or kind in the hands of the recipient, FBT imposes a tax on the provision of in-kind benefits (usually low-interest loans and use of motor vehicles) to employees. The design of the tax is a compromise between the Government's desire to block a burgeoning avenue of tax avoidance through the provision of fringe benefits and to find a method of taxing benefits which was politically acceptable to employees.

The use of fringe benefits as an alternative to cash income had been a long-standing practice in New Zealand. Some benefits developed out of the practice of transferring employees around the country on a regular basis; providing accommodation or loans was a natural way of compensating them. In the case of vehicles, some private use of these outside work hours, or for transport to and from the workplace, was a natural extension of the provision of a vehicle for work purposes. In an environment of high tax rates and a dispersion of company and personal tax rates, a useful tax wedge develops between the cost to an employer of providing a benefit in kind, and the cost to an employee of self-supply. In these circumstances, both the employee and employer benefit from the provision of a fringe benefit in lieu of cash salary.

In the period leading up to the 1980s, the giving out of fringe benefits exploded. A tight labour market for executives and professionals, apparent acceptance on the part of the Government, and rising marginal tax rates were strong motivating factors. The situation was clearly one of exploiting deficiencies in the tax system. Ideally, the value of such benefits should be regarded as income and thus taxed once in the hands of the employee. The convention that only benefits which could be turned into cash, and a reluctance on the part of the tax authorities to attack the deductibility of costs of providing fringe benefits, left the avenue wide open.

Fringe benefit tax addresses the issue of blocking an avenue for tax rate arbitrage, but it does so in a way which is inconsistent with tax policy principles. Basically, FBT is designed as a tax on the provision of services. In this respect, the design principles reflect indirect tax principles. However, it is widely accepted that taxing the supply of intangible services on a selective basis outside a market setting is one of the most difficult issues of tax policy design. Valuing payments in kind is inherently difficult, especially when individual circumstances vary the amount of benefit or the use made of an item like a vehicle. Those difficulties reflect themselves in the complexity of FBT. To overcome them, administrative valuations are used as the counterfactual for low interest loans. This has led to the situation where banks are charged FBT on staff mortgages on the basis of an assessed "market" interest rate, which exceeds the rate at which they lend to customers.

The Fringe Benefit Tax is rough justice but to a large degree it has been successful in stemming the growth of fringe benefits as an alternative to cash salary. This trend has been aided by a reduction in personal marginal tax rates, a closer alignment of company and personal tax rates and an improved availability of mortgage finance since the deregulation of the financial sector. While effective, FBT is nonetheless an anomaly, as it levies an impost on an employer for value received by an employee.

Special Partnerships

Special, or limited liability, partnerships were a convenient organisational device which became fashionable as a vehicle for tax-induced investment in agriculture, horticulture, bloodstock and films. Basically high-marginal-rate taxpayers sought relief from those taxes by investing in tax-preferred sectors.

As an investment vehicle, special partnerships gave investors the legal protection of limited liability, while allowing them to participate directly in tax losses generated by the partnership's investment. Unlike a company vehicle, the shareholders in the partnership suffered neither double taxation of income derived nor ring-fencing of losses. In many ways, the special partnership provided the kind of structure which imputation provides shareholders in taxpaying companies. Income derived from special partnerships was taxed – by a different mechanism – at the shareholder's marginal rate.

The special partnership was a convenient vehicle. By themselves, the special partnerships did not create arbitrage opportunities – disparities in tax rates and faster-than-economic-depreciation or the absence of a capital gains tax on tax-financed assets were the sources of opportunity. Nevertheless, the Government legislated against special partnerships in 1986 by deeming them for tax purposes, to be companies.

This piece of legal fiction effectively stopped the use of special partnerships. Investors could still take advantage of the tax arbitrage opportunities but had either to accept a greater degree of commercial risk or devise alternative structures. And, by this time, other more fundamental economic events causing asset prices to fall were reducing the attractiveness of tax-based investments in the rural sector.

All the same, treating a special partnership as a company is a distortion and is inconsistent with the broad thrust of the Labour Government's tax policies. While not a major distortion in itself, this treatment is an example of departure from a consistent policy framework.

International Tax Reform

The removal of exchange controls and floating of the New Zealand dollar in March 1985 weakened the administrative mechanisms for enforcement of foreign exchange transactions and transactions with non-residents. This left the tax system vulnerable to exploitation through the use of tax havens. While the development of provisions and devices to counter international tax avoidance was clearly required, the approach taken was to introduce quite draconian measures, affecting outward investment by New Zealand residents and with little attention being given to tax avoidance through inward investment. The measures proposed, and subsequently significantly watered down, stand in marked contrast to other tax reform measures and the overall approach to economic liberalisation.

The measures taken to address gaps in tax administration left by the removal of exchange controls developed over a period of time. Early steps sought to counter the use of tax havens for simple debt-equity conversions. These schemes accumulated cash in a haven through structures which allowed an expense to qualify for multiple deductions in New Zealand. Along with the introduction of accrual rules for debt instruments, the burden of proof was changed so that deductions for certain payments made offshore could be challenged by the Commissioner of Inland Revenue. The Commissioner was given the power to disallow deductions for payments made offshore unless supporting evidence was provided as to the validity of the payment.

Changing the burden of proof in itself was an important countermeasure, as it forced a reappraisal of the risks associated with haven-based financing techniques. When joined with the accrual rules, which made pre-paid interest structures less attractive, it was a major step to reducing the more blatant forms of exploitation by residents of deficiencies in the international regime.

The next step in the development of an international regime came in the 1987 Budget. This outlined a controlled foreign corporations regime (CFC) along the lines of those operating in the United Kingdom, United States of America, Canada, Japan, France and West Germany. The regime basically looks through tax-haven resident companies and ascribes a pro rata share of their income to the income of a resident shareholder. This practice makes the use of tax haven trusts and companies as tax avoidance vehicles less attractive to residents, while at the same time preserving their usefulness as bases for active investments. Although the CFC approach is far from perfect as a counter to international tax avoidance - it is expensive to administer and comply with - it does provide a barrier to the use of tax havens.

When the consultative document[4] on the New Zealand regime was released on 17 December 1987, it contained a major surprise for New Zealand resident shareholders in non-resident companies. The regime proposed was a significant departure from the CFC approach. It basically provided a ranking of valuation techniques for interests in non-resident entities. Resident taxpayers with a substantial or controlling interest which enabled them to obtain relevant accounting data would be permitted to calculate tax on their share of a non-resident entities income according to ordinary New Zealand tax rules. If this method failed, the shareholder could use the change in the market value of the interest in the entity as a proxy for the income derived.

Public attention focused quickly on the draconian nature of these proposed changes. Corporates with offshore investments would have to face significant compliance costs in compiling accounting information within a New Zealand tax framework. Individuals were outraged about the prospect of paying tax on changes in the capital value of their offshore portfolios without cash available from the investment to meet the tax.

From the Government's viewpoint, the proposal for a low 28 percent tax rate funded by these and other measures in the package was the compensation for loss of opportunities for deferring or sheltering tax through offshore tax havens. The commercial community, however, simply refused to accept the proposition and saw the international tax proposals as a misguided folly which never should have seen the light of day. Faced with such opposition, the consultative committee which took submissions on the proposals very quickly watered them down and produced a regime closer to the CFC model seen overseas.

It will remain a source of debate as to why the international proposals were developed and released in the form they were. From a technical viewpoint, the international tax regime is curious for what is left out, as well as for the degree to which the proposals over-reached practical considerations. From a political viewpoint, the proposals were disastrous, as they sapped business confidence in the Government at a time when a restoration of confidence was needed after the October 1987 sharemarket fall. They also reduced the Government's confidence in its tax policy advisors. The defeat of the international tax proposals has paved the way for greater opposition to other tax policy measures.

To date, the focus of reform has been exclusively on tax avoidance through outward investment by New Zealand residents. Little or no attention has been given to the well-known avoidance techniques of transfer pricing and thin capitalisation used by inward investors. Given the high degree of direct investment in New Zealand, and the prospect for more under the Government's asset sales policy, it might be thought that attention to inward investment would have been a higher priority than testing the theoretical limits of CFC-type regimes.

Future Directions

Two major policy issues face the Labour Government in the completion of its taxation reform programme. First, the Government has signalled that there will be further initiatives regarding the taxation of capital and that there remains much work to be done on business taxes in general.

At a technical level, the main concern will be to achieve a workable integration of the Government's tax reform initiatives with the basic structure of the income tax system that evolved in a different economic environment. Perhaps one of the most pressing examples related to this challenge is the deductibility of interest. Although the introduction of accrual rules addressed features of the tax status of interest and the timing of deductibility, a large question mark still hangs over the deductibility of interest in circumstances where the asset financed may generate non-taxable income, such as in the purchase of a company. These issues, while to a large degree of peripheral interest to tax policy advisors within the Government, are vitally important to the business sector, especially in a time of widespread economic change and restructuring. The apparent unwillingness of the Government to remedy deficiencies in this and similar areas, and the potential of disastrous financial consequences for a company where interest deductions are disallowed, create significant uncertainties which inhibit the process of change.

Second, and more in line with the wishes and desires of the Labour Party's constituency, the Government needs to address the issue of the impact of the tax system on labour market behaviour. This issue arises especially at the interface between the workforce and the social security and public housing systems. Poor co-ordination between these different parts of the fiscal system have produced poverty traps and unintended distortions which inhibit mobility and the willingness of low-income people to accept paid employment.

Despite reforms in 1986, and the subsequent lowering of marginal tax rates which took effect from 1 October 1988, some of the highest effective marginal tax rates in New Zealand are faced by people with dependants on low incomes or who receive social security benefits and housing assistance. Social security and tax are, to a large degree, co-ordinated. Since both provide monetary assistance to people according to their circumstances, this co-ordination is relatively easily achieved. However, the housing assistance system, which provides direct assistance and is also income related, is not co-ordinated. The result is that housing assistance recipients can face marginal tax rates of 80 percent on additional dollars of income earned. This provides a strong inducement to tax evasion and encourages people in these circumstances to remain in that situation. In turn, dependency on social security is also encouraged - most housing recipients are social welfare beneficiaries - while geographical mobility and willingness to take paid employment are discouraged.

These reforms both involve considerable amounts of work and are unlikely to yield fiscal benefits. Previous reforms have tended to concentrate on yielding higher revenue, although today the scope for such yields is diminishing. Both are important to the efficiency of the economy and to removing the uncertainties and distortions which adversely affect New Zealand's economic performance.

Conclusion

Tax reform has been a policy platform for the Labour Government in New Zealand since its election in July 1984. A considerable amount has been achieved in a short time towards the objective of creating a uniform and low marginal rated tax system. In this respect, the reforms have reduced the scope for the tax system to distort decision-making in the economy. However, the process is not over, and significant uncertainties and lack of neutrality still remain. Moreover, some of the measures that the Labour Government has itself introduced do not fit well within its own policy framework.

A general result of the Labour Government's tax reform package has been an increasingly complex tax system, taken as a whole. Certainly, for the majority of small and medium-sized business in New Zealand, tax reform has produced a greater amount of adminstration of more complex tax requirements. Even though these businesses now face a lower overall marginal tax rate environment, their average tax rates have not fallen – and the Government's demand for revenue remains undiminished.

Notes

1. *Report of the Task Force on Tax Reform*. Wellington, Government Printer, April 1982.
2. Douglas, R. O. *Statement on Tax and Benefit Reform*. Wellington, Government Printer.
3. *Government Economic Statement, 17 December 1987*. Wellington, Government Printer, 1987.
4. *Consultative Document on International Tax Reform*. Wellington, Government Printer, December 1987.

Chapter 8

INDUSTRY AND TRADE POLICIES

David Galt*

New Zealand from the 1950s to the 1980s had a range of relatively well established industry and trade measures. These were more a set of responses to evolving industrial experience than the result of adherence to any one philosophy of industrial development. Important measures included the continuing protection of local industry from import competition; the encouragement of export and import substitution industries through fiscal measures; the use of price controls to restrain inflationary pressures and monopolistic behaviour; and controls on participation in a number of industries. Since the 1960s, major political parties had usually agreed on the desirability of these measures, but from the late 1970s, changes were introduced in many areas, especially those which prompted a downward easing of protection levels and more competition in certain industries.

Accelerated changes to industry and trade policies were amongst the earliest and most far reaching of the measures introduced by the fourth Labour Government after its election in July 1984. The phasing out of the main export incentive scheme and an increase in import licence access to a minimum of 10 percent of the domestic market for most licensed imports were announced on 15 August. These first industrial measures opened the gate to a rapid transformation of industrial and trade policies.

The first section of this chapter defines the scope of industrial and trade policies and the climate leading to current industrial policies. An account of what was actually done from August 1984 to February 1989 follows in Section 2. The results of the changes and future directions are discussed in Sections 3 and 4, with conclusions drawn in Section 5.

1. Scope of Industrial and Trade Policies

Finding a straightforward definition of industrial and trade policies

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is not an easy task. In the United States, "industrial policy" refers largely to a debate conducted in the early 1980s over the extent to which government should intervene sectorally in industry to boost international competitiveness, save jobs and counter a process of deindustrialisation.[1] More recently, the concept of even having an industrial policy has come into question. The authors of a recent British white paper, when discussing "industrial policy", go so far as to say:

> The phrase itself is unfortunate, because it appears to concentrate on industry rather than consider all the factors which affect the ability of industry and commerce to create wealth; it also carries the flavour of DTI [the British Department of Trade and Industry] taking responsibility for the fortunes of individual industries and companies.[2]

These British concerns are equally relevant in New Zealand.

The meaning of trade policy, too, can be less than transparent. In New Zealand, it has often been taken to mean efforts to secure access to foreign markets; overseas, it is more likely to refer to the whole set of policies which affect trade, including import restrictions.

For the purposes of this chapter, industrial and trade policies will simply be taken as those government measures intended to have a direct impact on industry and commerce. Trade policies can then be seen simply as a subset of industrial policies. In keeping with this definition, those policies usually seen as affecting factor markets, such as macroeconomic, financial and labour policies, are generally not discussed, even though they have an obvious impact on industry.

The discussion goes beyond manufacturing to encompass agricultural and other primary and service industries, as the Government itself has increasingly set the agenda for debate by adopting policies affecting all sectors. Inevitably, some measures are not discussed.[3] Changes to the operation of state-owned enterprises have been discussed in Chapter 6, although they too might be seen as an important part of industrial policy.

Given an inability to produce a tight definition of industrial policies, it is tempting to seek a government policy statement which defines what is covered. There are a number of documents that one can turn to – election policy documents, budget and economic statements and press statements announcing individual policies. None of these fully sets out in one document the thinking and policy moves adopted, which is understandable given both the need to adapt policy as the economic environment changes and to continue debate as policy evolves. Perhaps the most comprehensive document has been the 1984 Labour Policy Document Statement on Industrial Development Policy, which stated:

> The overall objective of Labour's Industrial Development Policy is to promote the growth of New Zealand industry. A strong partnership between industry and government is needed to ensure sustained and balanced economic development. Labour wants to develop new job opportunities in industry, and to achieve earnings and savings in foreign exchange from increased exports and import substitution.[4]

Other parts of the policy statement set out a strategy which acknowledged the importance of macroeconomic measures for promoting growth, recognised that policy must be based on New Zealand's advantages, acknowledged a reduction in protection as an "important long-term objective" and emphasised the "overall political and economic environment". It then detailed a large range of issues which have been reflected in policy moves since: measures which have affected the business environment, employment, competition policy, commercial law, overseas investment and import licensing; encouraged new industries; affected the Industries Development Commission; and promoted research and development.

Trade policies were also set out in the 1984 Policy Document and introduced with the slogan, "New Zealand's life blood is its export trade". The document diagnosed the problem of slow adaptation from a production-led to a consumer-led approach. The solution was seen in establishing a global marketing strategy, to be led by the Minister of Overseas Trade and Marketing, and the setting-up of a market development board. Development of marketing policies and aggressive promotion of New Zealand's interests in the European Economic Community, the Closer Economic Relations Agreement with Australia (CER) and the General Agreement on Tariffs and Trade (GATT) were highlighted. Further policies were set out in detail for the agriculture, energy, fisheries, forestry and tourism industries, and statements were made about regional development and small business.

The incoming Government in 1984 clearly had comprehensive industrial policies, which foreshadowed well the scope of industrial policy over the following four years. However, it is to the measures implemented that one must look for the best definition of industrial policy rather than any particular statement.

2. The Measures

Background

Perhaps one of the best summaries of the principles behind New Zealand's recent industrial policies is provided by the Organisation for Economic Co-operation and Development (OECD), with the benefit of an outside perspective in its 1986/87 New Zealand Economic Survey:

> The new policy approach is based on the following principles:
> (a) Optimal use of resources is best promoted by allowing economic agents to pursue opportunities within a competitive environment subject to government intervention to secure rights, assign costs (in the case of market failure) and reduce transaction costs;
>
> (b) Such a competitive environment can be best promoted by enhancing contestability of product and factor markets through removal of unnecessary impediments to market entry and by ensuring that government interventions are as neutral as possible given the objective of the intervention;
>
> (c) Intervention can improve equity by increasing access to markets and by targeting assistance to disadvantaged individuals and groups;
>
> (d) However, all interventions need to be assessed to ensure that the gains outweigh the costs, based on a realistic appraisal of their effects, taking into account the difficulty of achieving appropriate incentives and accountability, particularly in the public sector.[3]

The OECD then identifies several categories of structural policy measures of which two are relevant to industrial policy:

> iii Reducing relative price distortions by cutting subsidies, lowering effective rates of protection and rendering indirect taxation as "neutral" as possible. The decision to let the New Zealand dollar float freely is also to be seen in this context;
>
> iv Raising the efficiency of the non-traded goods and services sector through increased competition, in order to ensure an equitable distribution of the burden of adjustment.[4]

A point worth noting is that the OECD perceives New Zealand to be "applying the strategy advocated by the OECD Ministerial Council in the wake of the second oil shock". Moreover, it sees New Zealand as applying the strategy "more comprehensively and systematically" than other OECD members.

Out of the OECD's summary can be drawn several recurring themes evident in the Government's industrial policy: neutrality of treatment across sectors; promotion of competition; a concern for equity; and a continued willingness to intervene where clear benefits would ensue, or where particular individuals and groups are seen to be disadvantaged.

Several other themes must be added to aid an understanding of the environment in which the current industrial policy has emerged. Much impetus for seeking an improved economic performance came from a general dissatisfaction with the level of growth being achieved, arising from a comparison with overseas living standards.[7] By 1985, New Zealand's real per capital GDP was 15 percent lower than in Australia and 39 percent lower than in the United States.[8] There was also a sense of crisis brought about by the run on the New Zealand dollar that accompanied the 1984 election. Moves were made towards industrial measures which meshed with macroeconomic measures. For instance, reduced government spending on industrial subsidies and assistance measures stemmed partly from the need to reduce the fiscal deficit (which reached a high of almost 9 percent of GDP in 1984) and its contribution to inflationary pressures. Perhaps most important was the osmosis of certain theoretical economic concepts into policy-making. There was an increasing realisation that high levels of industry assistance might simply end up locking resources into low-return uses. Acceptance of the desirability of relatively free trade amongst economists internationally influenced New Zealand thinking. Contestability theory also made an appearance, with its suggestion that oligopolists may be constrained by the threat of potential entrants.[9] Transaction cost and property rights analysis became increasingly important. The former concentrates attention on why firms organise transactions as they do, often leading to the conclusion that direct government regulation of a market is less effective than it might first appear. Property rights analysis tends to suggest that spillover effects from market transactions on third parties can be taken into account by establishing tradeable property rights. A New Zealand example is the introduction of tradeable fishing rights quotas to help prevent the depletion of scarce fisheries resources.

Import Licensing

Removal of import licensing is probably more symbolic of change than almost any other measure. The import licensing system first came into being in 1938, largely as a response to balance of payments difficulties. Some dismantling was attempted in the 1950s, but by the end of the decade licensing was again firmly entrenched as a balance of payments tool and as a protective device. Manufacturing development was seen as a route for achieving growth and diversifying away from dependence on a narrow range of pastoral farming exports: wool, meat and dairy products. Licensing ensured that manufacturing growth could take place, based on the general principle that if it could be made locally, licences would not be issued. Although tariff levels were high, they were less relevant in this environment. Provision for competing imports was very limited and was made mainly on the basis of licence entitlements rolled over to the same firms each year.

Some imports were removed from licence control during the 1960s, but these were generally goods not made locally. The first real step towards official acknowledgement that licensing ought to be removed came at the National Development Conference held in 1969. The Conference accepted that licensing should be removed in favour of tariff protection, on the grounds that this would encourage competition, efficiency, reasonable prices and wider consumer choice.[10]

There was increasing awareness that import licensing would not solve continuing balance of payments difficulties, as imports simply switched from final goods to intermediate goods and raw materials. Under a licensing system, it was possible for very high effective protection to be offered to some goods, with little public awareness of just how much assistance was being provided. This could mean that resources were attracted into relatively high cost industries, at the expense of more competitive industries (particularly export industries), and that incentives to innovate and seek efficiency gains were reduced. In some industries, manufacturing became fragmented, with relatively large numbers of firms producing on a small scale the wide range of product lines needed to satisfy total New Zealand requirements.

Despite the National Development Conference's recommendation, little was actually done until the mid-1970s, when an officials review committee was set up with the objective of recommending "adequate" tariff levels. A revised tariff was issued in 1978. This at least paved the way for a move to tariff-based protection, although the committee found itself unable to make tariff recommendations for certain relatively highly protected industries, including motor vehicles, textiles, clothing and footwear. These were referred to the Industries Development Commission for detailed reviews.

The breakthrough came in 1979. In that year's budget, the Minister of Finance announced two new licensing policies. The "MEPQD"[11] policy allowed for manufacturers to be issued licences for inputs where the New Zealand product involved "manifestly excessive price, quality problems or demand compared with imports". More importantly, import licence tendering was announced and then introduced in 1981, initially for 5 percent of the domestic market for a limited range of consumer goods. The tendering system was, in many respects, the key to phasing out licensing. Those obtaining licences could be seen to be paying for the privilege. Tendering exposed the very high levels of protection applying to some goods but, for most, it demonstrated that import licensing was a less important protective instrument than had often been thought. It became clear that many manufacturers would survive without licensing.

By 1983, the New Zealand Manufacturers' Federation, concerned at the likely direction of protection policy, requested that "summit" consultations be held with ministers. The result was a "Philosophies, Objectives, Strategies" document, which reaffirmed that the objective of protection policy was "a gradual and predictable movement towards the use of the Customs Tariff as the primary means of protection."[11]

Three other factors in the early 1980s cleared the path for a more rapid movement on import licensing. By 1984, the Industries Development Commission was well through its programme of industry studies, and officials groups had also tackled a number of areas of relatively high protection.[12] While the recommendations varied in each case, the government's subsequent moves generally involved the introduction of licence tendering, tariff adjustments and some measures to assist the industries - mainly the loosening of regulations or fiscal assistance. Some 40 percent of manufacturing was consequently covered by a specific industry plan, which took the industries concerned outside the scope of general industry assistance policies, but nevertheless involved reductions in assistance.

The advent of the Closer Economic Relations Agreement (CER) with Australia in 1983 further reinforced the momentum for reform. Under the agreement, most tariffs were to be phased out by 1988 and quantitative restrictions by 1995. There was a high level of acceptance amongst manufacturers for these moves because of the prospect of more secure access to the Australian market, the relative competitiveness of New Zealand manufacturing vis à vis Australia and, once again, the willingness to negotiate special arrangements for "difficult" industries. What CER brought to the general industry assistance reform process was a demonstration that New Zealand industry could successfully compete with a major trading partner.

Finally, the sharp 20 percent devaluation of the New Zealand dollar of July 1984 further increased the competitiveness of New Zealand industry. With the Labour Party already committed to address import licensing in its election policy, the time was ripe for moving further: hence, the August 1984 announcement that tendering would be extended to allow at least 10 percent of the market to be supplied by imports for most goods outside industry plans ought not to have been a surprise.

The atmosphere for reform was developed further in September 1984 at an Economic Summit Conference, with representatives drawn from a wide range of sectors. The Conference provided the Government with a consensus that New Zealand faced economic problems and that changes would be inevitable.

The November 1984 tendering round saw $438 million of imports tendered, with an average premium of 6.7 percent. In 1985 and 1986, tendered access was progressively raised to 15 percent and 20 percent of the estimated domestic market for the goods. Through the period, as tender premiums dropped below 7.5 percent, licences for those items were issued on demand. Some items moved to exemption. The final general tender round in 1987 offered only 110 categories compared with 660 in 1985, despite new categories being offered in the intervening period. The reason for the drop was that many items had already moved to exemption (or licence on demand).

By 1986, the Government was able to announce its intention to end import licensing, other than under industry plans or special arrangements, as of 1 July 1988. Compared to earlier moves on licensing, the announcement stirred little public excitement. The focus of the industry assistance debate had already passed to tariffs, which were clearly providing the bulk of assistance to manufacturing. Substantial changes were simultaneously made to licensing under industry plans. As early as 1984, a number of plans provided for elimination of all licensing, although over periods stretching as far ahead as 1992. Electric motors became exempt from licensing in 1986, and electronic goods followed in 1987. By February 1988, the only goods for which a final phase-out date had not been announced were apparel, adult footwear and wheatflour.

Tariffs

New Zealand tariffs were first established as a significant protection mechanism in the 1880s, extending in coverage but remaining at rates of around 20 percent through the 1930s.[13] By the 1970s, typical rates for final goods manufactured in New Zealand were often around 30 to 40 percent, although rates varied enormously. Tariffs on intermediate goods and raw materials were generally far lower.

Significant tariff reductions began under industry plans in the early 1980s. An example was ceramic tableware. The plan provided for elimination of a highly protective threshold duty, which imposed a tariff to raise the cost of cheap tableware to certain minimum levels – sometimes doubling the cost of imports. Early industry plans, however, generally provided only for tariffs to be set after a period of licence tendering, to "test" the level of tariff protection likely to be necessary.

Tariffs came in for earnest attention in 1985, when the budget signalled the Government's intention to reduce high tariffs on goods outside industry plans. After discussions, in which manufacturers strongly resisted reductions and argued for needs-based assistance, the Government announced that tariffs above 25 percent would be reduced in two steps. The cuts were 5 percent in 1986 and 10 percent in 1987, although tariffs above 50 percent were cut somewhat more.

Tariffs on some 500 items not manufactured in New Zealand were cut at the end of 1985, in most cases to nil. Specific rates, which afford higher protection to cheaper items, were converted to *ad valorem* rates. On a small number of items of interest to the farming sector, including gumboots, there were further reductions on 1 January 1987. Particularly significant was the decision in 1986 to establish preferential rates for developing country imports at 80 percent of normal rates for most goods, as these cover most imports from NICs (newly industrialised countries).

A review of long-term tariff setting principles was foreshadowed for 1988, but after concerns were expressed by manufacturers about the need to clarify the position, a Tariff Working Party was established in January 1987. With representatives of major business groups, unions and officials, it reported on 30 September 1987 that "There is scope for a significant reduction in tariffs."[14]

After receiving the report, the Government announced in December 1987 that a programme of substantial cuts in tariffs over four years, starting in July 1988, would be implemented, using the "Swiss formula", under which higher tariffs reduce faster, as shown in Table 1:

Table 1 Effects of General Tariff Cuts

Initial Tariff 1988 %	Final Tariff 1992 %
20	12.5
30	16.0
35	17.5
40	18.5

Industy plan tariffs also continued to be cut. Tariffs on electronics goods manufactured in New Zealand are to be reduced to 25 percent and plastics tariffs to 20 percent by 1990. A substantial cut in motor vehicle tariffs from 55 percent to 35 percent was announced in 1987, although the effect on motor vehicle assemblers was largely balanced by even steeper cuts to tariffs on locally manufactured and imported components.

Export Incentives

From 1962 onwards, export incentives were made available to exporters of non-traditional products, initially in an effort to diversify New Zealand's export base and help overcome the perceived balance of payments constraint. Through time, the coverage and value of these schemes grew. From 1979, the major incentives were the EMDTI (Export Market Development Taxation Incentive), which provided a subsidy to marketing expenses, and the EPTI (Export Performance Taxation Incentive), which provided a tax credit of 14 percent of domestic value added in respect of export earnings.

A raft of other measures also assisted exports – special financing facilities through the Reserve Bank, the non-profit insurance services of the Export Guarantee Office, free Trade and Industry trade promotion services, export suspensory loans, preferential import licensing treatment, an investment allowance and exemption from sales tax for machinery used in export production. A crawling peg depreciation of the New Zealand dollar was also targeted at export competitiveness from 1979 to 1982.

To some extent, it was argued that these measures provided "tariff compensation" by compensating exporters for the high costs they faced because of assistance to import substitution. The main impetus, however, came from a continuing perception that export earnings were desirable in their own right.

Meanwhile, the fiscal cost of incentives mounted ($259.6 million of credits in 1981/82 increased to $434.8 million in 1983/84). To compound matters, the United States Government in 1981 extracted an undertaking from New Zealand to remove its incentives by March 1985 or risk losing the benefit of an injury test when facing countervailing action on New Zealand exports to the United States. A report prepared by Syntec Economic Services for government departments in 1984 established that export incentive assistance across sectors, like the protection for which it was held to compensate, was in fact highly variable and uneven.[15] Under CER, New Zealand had also had to undertake to phase out incentives on exports to Australia.

The combined weight of these factors, and the additional competitiveness brought about by the 1984 devaluation, led to the demise of the EPTI in August 1984, with the announcement that it would be phased out by 31 March 1987. Export suspensory loans and special Reserve Bank financing facilities were also abandoned. The EMDTI lasted longer, but in 1985 it was announced that it would be phased out from 1987 to 1990. Trade promotion services supplied to exporters by Trade and Industry were placed on a partial cost recovery basis, to rise to 35 percent in 1988/89.

The Government's commitment to exporting nevertheless remained. The Overseas Trade and Marketing Minister, Mike Moore, led a number of highly publicised overseas marketing missions and achieved the promised establishment of a Market Development Board. The Board was then offered $20 million, with which it established an individual exporter programme (IEP) targeted at small exporters. In December 1988, the Board and Trade and Industry's promotion services were combined in a new Trade Development Board.

Efforts to secure overseas access for exports also remained undiminished. Two initiatives stand out. At the outset of a five-year review of CER scheduled for 1988 under the Agreement, the New Zealand and Australian Prime Ministers indicated that they would be looking to bring forward the dates at which free trade would be achieved and that they would consider an extension of its rules to cover services. Both goals were achieved, with the final date for free trade in goods being brought forward by five years to 1990 and arrangements for trade in a wide range of services being agreed on. New Zealand, however, was disappointed that Australia did not agree to cover a wider range of services in the Agreement. Also, New Zealand embraced the Uruguay GATT round with enthusiasm, looking for the extension of the GATT system to cover agriculture and services, improvements in the GATT dispute settlement mechanisms and further reductions in foreign trade barriers. Progress was slower in the GATT round than in CER, which was at its mid point at the date of writing.

Agricultural Support

As with manufacturing, New Zealand has had a long-standing programme of support for agriculture. The main elements have been helping settlement of new farmers; assisting the marketing programmes of producer boards; price stabilisation schemes; and input subsidies, including those for research and fertilisers. The underlying purposes of these measures were often portrayed as maintaining farmer confidence and export earnings, of which agriculture had accounted for the greater part for more than a century.

Until the 1980s, assistance levels generally remained low. In 1979/80, total assistance to pastoral agriculture was $312 million dollars, but in effective assistance terms the total subsidy effect has been estimated at as little as 1 percent.[16] However, after 1980, agricultural subsidies rose steeply, largely under "supplementary minimum price schemes" (SMPs) for meat and wool. The combination of weak international price levels and rising SMP levels escalated price support assistance from $26 million in 1980/81 to $1,231 million in 1983/84, the peak year. Total assistance to pastoral agriculture reached $1,709 million, with the effective rate of assistance being estimated to reach 314 percent.[17]

The withdrawal of assistance from agriculture was faster than the speed with which it had been put in place and significantly faster than in the manufacturing sector. SMPs and their replacement in the form of a temporary lump sum support payment scheme for the 1984/85 season ceased. It was confirmed that producer boards would have to obtain future finance at commercial interest rates. Previously, finance had been available at rates as low as 1 percent. In the process of removing these special facilities, the Government agreed to write off losses of $600 million incurred by the Reserve Bank in ending Dairy Board facilities and $1,029 million in respect of Meat Board farm income stabilisation scheme losses.

The November 1984 Budget announced that interest rates on Rural Bank finance, which had historically been available at concessional rates for purposes such as farm purchase, were to be raised progressively to market rates and a farm vendor finance scheme ended. Input subsidies were to be ended or reduced for fertiliser, irrigation, certain investments, noxious weed control and product inspection costs. In further moves in 1985 and 1986, land development concessions and concessional tax treatment of livestock were discontinued. Many Ministry of Agriculture and Fisheries services moved to a cost recovery basis.

The result by 1987 was that, in real terms, net assistance was less than in 1980, with a substantial proportion of remaining assistance being due to commercial interest rates outpacing those concessional rates still available. Price support had virtually disappeared, except to the extent that the producer groups wished to implement their own. The Government remained willing to provide assistance in the event of major droughts or floods, but was careful to ensure that this was consistent with the overall direction of restructuring within agriculture.

For the most part, producer boards retained a major role in marketing, despite increasing debate over the merits of single seller export marketing. The Government brought kiwifruit export marketing under the direct control of a board in 1988, removing it from the hands of a limited number of licensed private exporters. However, lamb marketing was returned from the New Zealand Meat Producers Board to private companies in 1987. Long-standing controls over wheat and flour administered by the Wheat Board were removed in January 1987, with wheat prices to farmers dropping to world levels. This precipitated anti-dumping action by United Wheat Growers Ltd against Australian imports. In July 1987, the Government made a one-off grant of $25 per tonne of wheat for the 1987 season, in response to which the company withdrew its complaint. Specific assistance had earlier been offered to grape growers after surplus production had led to a sharp drop in prices. This resulted in the removal of 25 percent of the national vineyard area prior to the 1986 harvest.

In the face of reduced output prices and higher interest rates, numbers of farmers encountering financial difficulties escalated. The most visible government response was the introduction in July 1986 of a Rural Bank Mortgage Discounting Scheme. Under this, the bank offered to discount the principal, but raise the interest rate on loans, leaving cashflow unaltered but increasing farmer equity, in order to facilitate debt restructuring.

Other Industry Policy Measures

Alongside import licensing, tariffs, export incentives and agricultural measures have been a number of less well-known industrial policies. Amongst the more significant have been competition and industry entry measures, research and development, regional development and government direct investment policies.

Competition Policy

The major competition policy measure is the Commerce Act 1986, which replaced a similarly titled act of 1975. Its stated purpose is "to promote competition in New Zealand", which it does primarily by providing for a competition test for certain mergers and takeovers and banning many trade practices which have the effect of reducing competition. The Act also provides for price controls to be imposed in certain industries.

Changes to the 1986 Act included raising the size threshold at which mergers must be notified to the Commission and giving the trade practice provisions more teeth. Arrangements which "substantially lessen competition" are generally prohibited (but may in some circumstances be authorised if there is a net public benefit), while companies having a dominant market position are prohibited from using that position to limit market entry. The emphasis in the current Act has changed, in line with economic thinking, to emphasise behaviour rather than the apparent structure of markets. Private legal actions have also been permitted under the new Act, and several have occurred.

A marked scaling-down in the use of price control as a policy instrument has taken place. Although one of the first steps of the Government after the 1984 devaluation was to extend a general price freeze until November of that year, most items controlled under the Commerce Act have since been exempted. Promotion of competition through market liberalisation means that price control is now seen very much as a "last resort" policy tool.[18] Only natural gas and milk remain under control, under the Commerce Act. Price controls under other regulations have also been liberalised, notably in the case of motor spirits, where price restrictions have been removed.

An important aspect of competition policy has been the continued move towards a more proactive stance in administration. The process started before 1984, with entry to the freezing industry, road transport and foreign exchange dealing being opened. Since 1984, the process has accelerated. Reviews have been undertaken specifically to determine whether more competition might be introduced in motor spirits distribution and the gas industry and are being initiated for many professional groups as occupational licensing comes under scrutiny. Reviews also lead to decisions to liberalise entry into broadcasting and telecommunications from July and April 1989, respectively.

Part of the impetus for moves to promote competition has been a greater concentration on the interests of the consumer. This has also been reflected in establishment of a Ministry of Consumer Affairs, introduction of the Fair Trading Act 1986 and a willingness to strengthen regulations promoting consumer safety and bargaining positions.

Research and Development

Historically, the major government support for Research and Development (R&D) has come from direct funding of research, especially for the agricultural sector. Indeed, most New Zealand R&D has been government funded.[19]

R&D policy has, since 1984, been the focus of increased debate following Australian introduction of a generous 150 percent tax deductability concession for R&D spending. A committee led by Sir David Beattie in 1986 recommended similar support measures in New Zealand[20], and industry groups such as the New Zealand Manufacturers' Federation have argued strongly for encouraging R&D as other assistance measures have phased down.

Government moves have included removing accelerated depreciation provisions for equipment used for R&D, widening the eligible range of R&D expenses which may be offset against income for tax purposes, and increasing the proportion of expenses which must be recovered by government research and technology organisations. This is seen as providing for greater responsiveness to the needs of users of government research, as well as being consistent with fiscal and industry assistance policies. A number of grant-based schemes have been phased out.

Regional Development

When introduced in the early 1970s, regional development assistance policies were chiefly directed towards encouraging manufacturing in certain priority regions. These regions were largely characterised by outward population drift or distance from metropolitan centres. Gradually, through time, the range of industrial activities which were supported expanded beyond manufacturing.

Since 1984, a substantial reorientation of policies has occurred, aimed at placing more responsibility for development in the regions themselves and facilitating structural change. This is best reflected in the replacement of regional investment incentives with investigation grants, abolition of the distinction between priority and non-priority regions and the extension of the main assistance measure to cover any legal activity in all regions. Overall funding remains small.

Direct Investment Activity

Direct government involvement in industry has been drastically reduced since 1984, following the completion of the large energy- and resource-based projects initiated by the National Government. At one point, these accounted for 20 percent of total manufacturing investment. They included expansion of New Zealand's steel and oil refining capacity and direct government investment in methanol, ammonia urea and synthetic petrol plants. A combination of falling international prices and cost overruns in the face of government guarantees for the international debt used to finance the projects resulted in the Government having to inject additional capital into the projects and take over substantial debt commitments. In the process, the Government became increasingly reluctant to participate directly in further investment projects. Since 1987, it has moved away from direct participation in commercial activities by selling all or part of its shareholdings in New Zealand Steel Ltd, the synthetic petrol plant, the Maui gas contracts, Air New Zealand Ltd, the Bank of New Zealand Ltd and Petrocorp Ltd. Further asset sales were foreshadowed even though the sales programme was the cause of heated debate within the Government and the Labour Party during 1988.

3. Results

The major trends which emerge from examining industrial policy since 1984 can be summarised as a comprehensive reduction in specific industry assistance measures, promotion of competition, withdrawal from direct government investment and a greater dependence on macroeconomic measures for tackling macroeconomic problems, tinged with a willingness to use alternative measures for specific situations. Up to four years after these policy changes began, it is still difficult to find a comprehensive account of what the results have been. There are a number of good reasons.

The comprehensive, widespread nature of the changes makes it virtually impossible to isolate out the effects of particular changes. In the case of industrial policies, the effects of macroeconomic policies which have contributed to higher interest rates, exchange rates and tighter fiscal and monetary policies are particularly difficult to disentangle. Change on this scale represents an unprecedented challenge to modelling techniques which might potentially be used to investigate the effects of the policy changes. Also, it takes years for the effects of such policy changes to work through the system. In the case of United States airline deregulation in 1978, there still remains a booming "cottage industry" within which economists discuss the results.[21]

Another difficulty in assessing the outcome of the policy changes is to find a framework which can be agreed upon. Improved GDP, inflation, unemployment and balance of payments figures if achieved may not be enough, if wider social objectives are not met. Economic change inevitably requires trade-offs between goals and between points-in-time. The framework is often not explicit.

It is, nevertheless, possible at least to examine what major economic indicators reveal, even if isolating out the specific effects of industrial policy is well nigh impossible and future developments could radically alter the current position.

Production

Production data provide a reasonable framework for examining overall trends. The path of real GDP is set out in Table 2. The table shows an overall rate of growth of 1.4 percent per annum in real GDP in the three years to September 1987. By way of comparison, growth from 1978 to 1984 was 1.9 percent per annum. While growth has slowed since 1984, the general movement in output was clearly upwards until September 1987, with the major exception of the December 1986 quarter, following the GST boom. Interestingly, the recession which set in after September 1987 does not appear, at the time of writing, to have reduced output as much as that which occurred over 1982/83.

Agriculture

Some surprising features emerge from examining sectoral production trends. Perhaps most intriguing is the sharp increase in the contribution of agriculture to GDP, given the pressure the sector has come under. Undoubtedly, some of the increase will have come from temporary increases in output as farmers have reduced breeding stock. However, this is only part of the explanation. Ministry of Agriculture and Fisheries forecasts for the total period from 1984 to 1987 were for a decline in sheep numbers of 4.6 percent, offset by a rise in cattle numbers of 5.4 percent.[22] The net fall has clearly been small. Incidentally, the decline began in 1982, not 1984.[23] This suggests that pastoral farmers may well have been adjusting to international price signals before the removal of SMPs and other support measures, perhaps by switching to alternative farming styles, such as horticulture, deer and goats.

Statistics show that horticultural output has increased dramatically on the basis of earlier plantings. MAF forecasts were for a tripling in kiwifruit production (the largest component), from 1985 to 1988. Other horticultural crops have also increased sharply.[24] The horticultural output boom did not necessarily reflect in growers'

Table 2 Index Numbers of Gross Domestic Product at Constant 1982-83 Prices by Industry Group[1] [2]
(Base: 1982-83 = 100) (seasonally adjusted)

Quarter		Agriculture	Fishing, Hunting, Forestry, Mining (other primary)	Manufacturing	Electricity, Gas & Water	Construction	Trade, Restaurants & Hotels	Owner-Occupied Dwellings	Transport, Communications, Business & Personal Services (other services)	General Government Services	Gross Domestic Product
1982	Jun	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Sep	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Dec	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
1983	Mar	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Jun	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Sep	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Dec	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
1984	Mar	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Jun	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Sep	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Dec	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
1985	Mar	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Jun	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Sep	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Dec	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
1986	Mar	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Jun	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Sep	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Dec	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
1987	Mar	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Jun	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Sep	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible] [4]	[illegible] [4]	[illegible]
	Dec	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
1988	Mar	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Jun	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	Sep	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]

Notes:

[1] Year ended 31 March 1983.

[2] Quarterly Indices are expressed as annual equivalents.

[3] Indexes for the six quarters ended September 1988 are provisional.

[4] The creation of new state owned enterprises transferred activity from government services to other services.

Source: Department of Statistics

returns, with kiwifruit exporters particularly facing a squeeze between higher interest costs and the effects of higher output on prices.

Deer and goat numbers, although small initially, have continued to increase, with MAF forecasting deer numbers to be 2 percent of total livestock numbers by 1992.[25] Despite a reduction in the tax incentives to build up herds, these new livestock industries seem to be underpinned by reasonable prospects for meat and fibre production.

There can be little doubt that some of the increase in agricultural output shown in the GDP statistics resulted from a cutback in expenditure on inputs, such as fertiliser and other capital items. Manufactured fertiliser sales dropped from 2,012,589 tonnes in 1984/85 to 1,021,959 tonnes in 1986/87.[26] Such drops in input expenditure may well show up in future output reductions. However, they probably also reflect a reduction in more marginal applications following the removal of subsidies, which may result in output falling less than expected.

Despite overall production holding up well, there can be no doubt that the agricultural sector has undergone a traumatic period of adjustment. Net real sheep and beef farm incomes dropped 39 percent from 1983/84 to 1985/86 and, despite an estimated 19 percent rebound in 1986/87, remained 28 percent below the 1983/84 level.[27] According to the Valuation Department's index, open market farm land prices, which rose sharply up to 1982, began falling in 1983, and by December 1986 were 17 percent below 1982 levels. For categories such as fattening and arable farms, prices fell far more sharply than the overall average.

Relatively few forced sales occurred up until 1987, but it was clear that there was a mounting debt problem even if not a production problem. The squeeze is illustrated by the rise in the percentage of farmers with less than 50 percent equity from 4.4 percent in 1983/84 to 23 percent in 1986/87. These farmers were paying an average of 36.7 percent of gross income in interest charges alone.[28]

By early 1988, there were at least some signs of an easing in the position of some farmers. While a further appreciation of the New Zealand dollar was intensifying pressure, rising overseas dairy prices, higher wool prices and the prospect of falling interest rates offered some prospect of relief. A private survey showed sheep farmers expecting to increase fertiliser expenditure by 42 percent, and dairy farms by 20 percent. All categories of farmers planned to raise construction expenditure 27.2 percent and land development expenditure 16.3 percent.[29] Farmland prices were, however, showing few signs of rebounding, and the sustainability of the position of highly geared farmers remained in question.

A year later in 1989, the picture looked considerably brighter, after further increases in dairy and beef prices and a decline in the value of the New Zealand dollar. Dairy farm prices were moving upwards again but sheep farming prospects remained depressed. Many farmers' debt problems still needed to be addressed.

Manufacturing

Manufacturing sector production shows a less healthy picture than that of agricuture. The manufacturing contribution to GDP peaked in the December 1984 quarter under the influence of that year's fiscal, monetary and devaluation stimuli, with that level not being reached again even in the GST boom quarter of September 1986. However, overall output by September 1988 remained above levels reached prior to 1982.

The overall manufacturing picture disguises a number of underlying trends. Real output over the period after 1984 was boosted by the "coming on stream" of the major energy and steel projects. Many manufacturers servicing niche markets have continued to expand.

New Zealand manufacturing remains overwhelmingly oriented towards the domestic market in spite of the historic growth in non-traditional manufactured exports after the 1960s. It is clear that much of the fall in output since 1984 can be accounted for by factors affecting the domestic market - tighter monetary and fiscal policies; the rural recession reducing demand for manufactured inputs and processing of agricultural products; and increased exposure to import competition. Exposure to import competition has, in turn, made overall international competitiveness far more important than in the past.

Just how much each of these factors had contributed to the fall in output is difficult to say. A tendency for overall manufacturing margins to increase is suggested by comparing movements in input and output prices from mid-1985 to mid-1987. This suggests that manufacturers may have faced relatively little adjustment pressure in the domestic market up until 1987.[30] The downturn in the domestic economy at that point showed up in increasing pessimism amongst manufacturers about domestic prospects. The New Zealand Institute of Economic Research Quarterly Survey of Business Opinion for December 1987, for instance, showed manufacturers to be much more pessimistic about the domestic economy than export markets. A net 32 percent of manufacturers expected domestic sales to decline; views of export prospects were evenly balanced.[31]

The rural recession had its greatest impact on manufacturers producing specialist products for the rural sector but, for most manufacturers, up until 1987, the effects were offset by urban buoyancy. For many manufacturers, pressure from increased imports was slow to be felt. In a September 1985 survey, for instance, none of the manufacturers interviewed had had to abandon a market to imports, although there was considerable apprehension about importing changes.[12]

By 1988, it was apparent from import statistics that imports competing with local manufactured products were starting to increase significantly, despite the lack of buoyancy in the domestic economy. September 1987 quarter manufactured goods import volumes (other than food), for example, were up 19 percent, and electrical machinery imports were up 58 percent, but general import volumes were up only 11.4 percent on 1985 June year volumes, according to the Department of Statistics.

Much of the effect of increasing import volumes was concentrated in industry plan industries, which had been subject to longer liberalisation programmes and had faced initial competitiveness problems. The motor vehicle assembly industry, for instance, faced a 35 percent drop in the number of unassembled packs imported for local assembly in the two years to June 1987, while the market share of foreign-assembled vehicles imported increased from 8 percent to 28 percent. Colour television set assembly, historically a large component of electronics manufacturing, was phasing down rapidly as imports increased.

Perhaps another indicator of changing import patterns was the sharply increasing shares of the EEC and Taiwan in New Zealand's total imports from 1984 to 1987. These finished goods sources increased the value of their exports by 57.1 percent and 183.7 percent respectively, while total imports rose 31.8 percent.

Export production in the manufacturing sector peaked in the year ended June 1985, recovering sharply from a drop in 1983, as shown in Table 3. Clearly, the manufacturing sector's ability to export declined after 1985, given the combination of rising domestic costs and the rise in the New Zealand dollar. However, the actual drop in export volumes was quite small – 4.9 percent from 1985 to 1987, about the drop in one year from 1982 to 1983 in the face of that year's Australian recession. Export volumes were increased somewhat by the major projects. Overall, it is apparent that manufactured export volumes have held up at least as well as levels of production for the domestic market.

Table 3 Index Numbers of Export Volumes by Industry Groups

June Year	Agricultural Production	Fisheries	Forestry	Fuel & Power	Mineral Resources	Manufacturing	All Groups Actual
1983	1119	1086	891	1180	1160	956	1077
1984	1086	1233	1039	1908	1521	1171	1129
1985	1175	1175	942	4951	1561	1347	1216

Continued Table 3

Table 3 Index Numbers of Export Volumes by Industry Groups

June Year	Agricultural Production	Fisheries	Forestry	Fuel & Power	Mineral Resources	Manufacturing	All Groups Actual
1986	1138	1258	963	6559	1458	1334	1198
1987	1300	1390	908	8765	1448	1299	1299
1988	1248P	1398P	117P	10004P	1544P	1281P	1264P
Quarterly							
1985 Sep	1058	1117	965	13872	1642	1436	1180
Dec	1083	1374	925	6396	1503	1526	1197
1986 Mar	1114	1367	903	5284	1017	1086	1106
Jun	1296	1263	1060	8686	1645	1287	1309
Sep	1361	1373	798	2599	1627	1382	1339
Dec	1127	1594	986	13583	1490	1361	1225
1987 Mar	1261	1368	910	2186	1150	1100	1210
Jun	1458	1266	937	16695	1526	1553	1419
Sep	1202	1134	1084	5044	1243	1408	1298
Dec	1082	1523	1176	6622	2044	1438	1263
1988 Mar	1318	1517	1073	15914	1342	1109	1303
Jun	1388P	1229P	1131P	22820P	1551P	1197P	1388P
Sep	1185P	1947P	1219P	8768P	1887P	1299P	1318P

Note: The normal seasonal pattern is for high volumes in the June quarter followed by lower volumes in the September quarter because of the seasonal pattern of agricultural production. This was disrupted in 1986 by a prolonged freezing industry strike, resulting in a deferral of exports from the June to the September quarter.

Source: Monthly Abstract of Statistics (Year to June 1982 = 1000; P = Provisional)

Some interesting conclusions might be drawn. It could be, as suggested by Robin Clements, a Reserve Bank economist, that manufacturers have cross-subsidised exports from domestic revenues, in an attempt to hold on to export markets.[33] Certainly, New Zealand manufacturers have a high export consciousness and are well aware of the costs of re-entering markets, having withdrawn from them.[34] Some switching from domestic markets to export markets may also be taking place, in the face of weak local demand. Perhaps more optimistically, despite widespread withdrawals from exporting, some manufacturers appear to be reaping the benefits of restructuring policies. In particular, better access to imported raw materials and components appears to be helping competitiveness in some instances.

Export results also tend to suggest that the loss of export incentives has had relatively little impact on exports. It appears that many manufacturers regarded them as cream on the cake. In fact, two (unrepresentative) manufacturers of a sample of thirty have gone so far as to say that the phaseout of export incentives encouraged them to increase export volumes to make up for lower profit margins.[35]

There are strong indications that many manufacturers have made considerable efforts to improve their competitiveness in the face of increased competition. Three surveys by the Department of Trade and Industry have gathered evidence of the types of adjustments manufacturers have attempted.[36] They show that more attention is being given to financial management. Manufacturers have moved to complement and rationalise domestic production through a move into importing. Product ranges, which under import licensing often required very small production runs to service the whole product range demanded, have been pruned back. New capital equipment has been installed, often to replace labour. Marketing strategies have been altered, including, for instance, moves to establish retail networks or private after sales service.

Despite these efforts, there has inevitably been retrenchment. In the face of increased Australian competitiveness with a depreciated dollar, a number of New Zealand manufacturers have transferred operations to Australia. Staff reductions have been widespread, as reflected in Table 4.

Table 4 Employed Persons by Industrial Activity

	1985 DEC	1986 MAR	JUN	SEP	DEC	1987 MAR	JUN	SEP	DEC	1988 MAR	JUN	SEP
Agriculture, Hunting, Forestry and Fishing	181.2	167.8	177.8	163.4	168.2	166.9	153.9	156.7	165.6	170.1	150.5	152.7
Mining & Quarrying	5.5	6.9	7.5	4.7	5.4	6.0	4.6	4.9	5.7	4.8	4.8	4.0
Manufacturing	319.2	327.8	325.9	306.7	311.5	311.1	309.5	293.4	291.4	286.5	275.2	264.2
Electricity, Gas and Water	15.8	16.1	15.6	16.9	17.8	16.5	15.7	17.1	17.7	17.6	15.9	15.4
Building & Construction	107.5	103.2	101.9	98.9	107.7	106.3	100.6	100.3	99.5	98.1	95.1	99.6
Wholesale & Retail Trade	313.4	296.4	287.8	297.1	302.9	307.2	304.8	311.9	314.0	298.9	303.7	293.6
Transport, Storage & Communications	105.4	105.4	106.0	111.0	114.9	109.8	113.7	109.4	109.9	109.7	109.8	102.1
Finance, Insurance, Real Estate, etc.	125.3	131.9	131.8	135.7	134.6	134.9	145.5	138.9	144.0	147.3	146.3	150.8
Community Services, etc.	388.7	382.1	387.1	395.2	385.3	391.9	396.2	406.7	412.4	402.4	400.2	393.8
Not Specified	8.2	7.4	7.9	7.3	8.0	7.5	6.1	4.3	6.1	4.6	3.9	2.9
Total	1580.1	1545.0	1538.3	1536.9	1556.2	1558.1	1550.6	1543.5	1564.4	1528.5	1505.4	1479.2

Source: Household Labour Force Survey data, released quarterly by the Department of Statistics

This shows that while total employment remained roughly constant from the December 1985 quarter, when the first results of the Household Labour Force Survey became available, until the December 1987 quarter, there was significant reduction in manufacturing employment. As the economy generally went into recession after December 1987, and employment fell in every category except Finance, Insurance, Real Estate etc., manufacturing continued to show one of the highest rates of decline. There has also been a marked trend towards part-time employment.

Of course, the counterpart to decreasing employment is increasing productivity. It does, in fact, appear that labour productivity in manufacturing has been increasing, despite falling overall output.

For those looking to the future of manufacturing, investment has long been a focus. At first sight, an examination of this indicator might seem to suggest a collapse of confidence: nominal investment fell from a peak of $2,498.6 million in calendar 1983 to $1,886.1 million in the year to September 1987. However, once these figures are adjusted to remove the effects of inflation and major project investment, which proceeded only on the basis of government guarantees, it can be seen that manufacturing investment is virtually unchanged from the 1983 level.[17] In fact, real manufacturing investment on this adjusted basis has remained remarkably constant at around $200 million per quarter (in 1982 dollars) since 1979, with the exception of two short-lived booms in 1981 and 1984/85. Whether this pattern will continue long term remains to be seen.

With the removal of foreign exchange controls, there has been a sharp increase in New Zealand manufacturing investment abroad. This has been particularly marked in the case of Australia, no doubt spurred on by the sharp depreciation in the Australian dollar since 1985. It is likely that some of this investment is at the expense of local investment, but equally likely that at least some represents a response to new opportunities and thus adds to the volume of investment by New Zealand manufacturers.

Other Sectors

While agriculture and manufacturing are the sectors widely perceived to have undergone the most adjustment since 1984, no account of industrial policy could be complete without examining other major sectors. Given that the more neutral stance of industrial policy is intended to allow resources to flow to where they can best be utilised, the key question concerns the growth rates achieved.

Table 2 shows that, since 1984, there have been declines in the contributions of trade, restaurants and hotels, and general government services to GDP. Slow retail sales growth accounts for the performance of the first group, while the government sector's performance reflects reductions in public sector staff numbers and transfer of activity to state-owned enterprises.

However, the Table also indicates that there has been strong growth in the other primary, construction, and other services groups. Generally, the growth shown in the statistics for these groups can be interpreted straightforwardly as representing increased output. An exception is the other primary group, in which reduced oil exploration expenditure shows up as higher net output but, even in this group, the overall upward trend remains strong.

The strong growth apparent in these sectors arises from a range of factors. The availability of technology and satisfactory international prices have provided incentives to develop natural resources. In the case of construction, sharply increased demand for hotel space for increasing tourist numbers and the need for additional office space to accommodate computers and a burgeoning services sector have raised output. The decline in output from mid-1988 onwards demonstrates that cyclical optimism also played a part in previous growth. The availability of new technology and deregulation allowing new entrants have boosted "other services" output particularly in communications, finance and air transport. For example, the 1987 start-up of Ansett's domestic air services in New Zealand following deregulation was accompanied by a strong surge in passenger numbers, even to the extent that Air New Zealand's load factor rose.

As Table 4 shows, growth in the services sector was sufficiently strong from 1985 to 1987 to generate enough jobs to nearly balance the losses in manufacturing and agriculture. The services sector continued to lose far fewer jobs proportionally in 1988, while overall employment fell sharply.

Growth in services employment dates back to before 1984, as did the bullish financial climate which prevailed prior to the October 1987 sharemarket crash. Services employment growth cannot therefore simply be attributed to industrial policy since 1984. However, a significant trend in industrial policy has been recognition of the importance of the services sector – in competition policy and deregulation, as an export earner, in New Zealand's enthusiastic pursuit of services issues in GATT and CER negotiations, and in the establishment of a specific services section within the Department of Trade and Industry's industrial wing, prior to that Department's restructuring in December 1988.

It is reasonable to expect that reductions in assistance to agriculture and manufacturing would benefit services *and* other primary activities, both in an enhanced ability to compete for resources and in an ability to obtain lower cost inputs. It is impossible to isolate out the full effects of industrial policies on the services and other primary sectors, but it is certainly clear that their growth up until 1987 was entirely consistent with the industrial policies followed.

4. Future Directions

As of February 1989, it would appear that the die has been cast. The Government has been remarkably consistent in its moves towards greater neutrality in the environment for investment decisions, reducing specific industry assistance, promoting competition and using macroeconomic measures, such as fiscal and monetary measures, rather than industrial measures, in its attempts to stabilise prices and produce the climate it seeks for industrial growth. The pace of change has varied through time and across industries and will continue to do so, but these directions seem clear. The Government's commitment to the policies of its first term remained firm throughout 1988 and was reaffirmed after the changes to the Cabinet late in the year. When the Government announced in February 1988 that its flat income tax proposals would be put on hold, it specifically reiterated its commitment to reduce tariffs substantially and to proceed with telecommunications deregulation.

A number of conditions are required for the industrial policy measures adopted to produce the results expected of them. One of the most obvious is time. Current policies dictate some movement of resources from highly assisted to lightly assisted industries. Such a process cannot be a short-term one, as there are many factors which tend to hold resources in current uses, including, for example, asset specificity and retraining costs.

A comfortable world and local business environment would certainly help the process of change. Adjustment not only requires resources to leave some activities, but also requires redeployment, which, in turn, is certainly encouraged by a positive level of business confidence. Adjustment up to 1987 definitely did occur in a positive business environment, against a background of world growth, willingness by the financial community to support investment decisions, and slow but positive economic growth. It will still take place even in a recessionary environment, but with potentially higher social costs.

There have been many arguments amongst economists over the "sequencing" of reform: should a government deregulate financial markets, labour markets or goods markets first?[18] Few definite conclusions have emerged from this debate to point to any particular steps which would assist the process of adjustment in New Zealand. One possible exception is the desirability of allowing firms facing adjustment pressures greater scope to spread the pressures beyond the firm itself. The ability to renegotiate with suppliers, creditors and unions as conditions change is important.

There has also been a debate over whether macroeconomic stabilisation should be attempted at the same time as industrial policy reform is undertaken. The argument is sometimes put forward that squeezing inflation through monetary policy has raised interest rates and the exchange rate, reducing international competitiveness at a time when it needs to be maintained to facilitate adjustment. International competitiveness has undeniably been reduced since the 1984 devaluation, but just how much remains a moot point. It is easy to confuse the loss of competitiveness as a result of changes in exchange rates or factor prices with a loss of competitiveness due to structural change. Competitiveness for some industries has also been enhanced by factors such as reduced industry assistance elsewhere and the fuller refund of input taxes to exporters available under a value added tax system like GST. In the final analysis, competitiveness can only be judged by whether a country can cover its foreign exchange requirements in the long term. Continued export growth suggests New Zealand did not have a severe competitiveness problem in the period under review. Concerns about competitiveness seem likely to abate if both the fiscal deficit and inflation continue to fall.

Further requirements for successful industrial adjustment include some critical non-economic factors. Present policies require many people to react in certain ways to take advantage of new opportunities: to seek to enhance their incomes and to be flexible enough to change occupations, lifestyles or places of residence. There are barriers to such flexibility, and their importance is difficult to assess. In 1986/87, 59.7 percent of the labour force had no post-school qualification,[39] which cannot help the process of changing employment. Cultural attitudes vary – not all people are interested in building their human or material capital as their top priority. Also crucial is continuing public support. For this, the results of the industrial programme will need to be demonstrable and tangible – higher incomes, different lifestyles and employment opportunities. It is too much to expect these results from an industrial programme alone, but widespread public benefit across the community will remain an important criterion for judging recent industrial policy.

5. Conclusions

Various statements of the Government's industrial policies exist, but for a clear view of what the policies are, the best place to look is to the policies themselves.

Indentifiable principles underlying the policies include a move towards greater neutrality amongst industries, phasing out of specific industry assistance measures, promotion of greater competition and a greater use of macroeconomic measures for purposes such as price stabilisation.

Policies adopted include removal of agricultural subsidies, import licensing and tariff reductions. Many remaining forms of government intervention have been made more general in nature (such as regional development measures), or targeted towards establishing an overall environment for business. There has been a new awareness of the importance of services in the economy. Some of these policies were in evidence before 1984, and have simply been intensified. In other cases, such as the reduction in direct government investment in the manufacturing industry, there has been a sharp break with previous practice.

More time is required for the results of the policy changes to become fully apparent. At the beginning of 1989, available statistics showed that different industries were having markedly different experiences. Agricultural net output was increasing despite traumatic conditions for some farmers and lingering debt problems. Manufacturing output was dropping, while services and other primary industries were holding up well despite the demand recession. Overall employment was roughly constant in the two years to December 1987, but demonstrated a large-scale shift out of agriculture and manufacturing into services. These sectoral trends remained apparent throughout 1988.

A number of question marks exist, particularly about the likely effects of the 1987/88 domestic recession and the world economic climate. Up until the end of 1987, the Government remained firmly committed to its industrial policies, and the overall results of them, as revealed by available statistics, were probably less dramatic than many had feared. A marked improvement in business confidence at the end of 1988 may herald the first real opportunity for a fair test of the Government's trade and industrial strategies, with the picture less clouded by deflationary macroeconomic policies. Can the hoped for long-term gains take the New Zealand economy to both a higher level of activity and a higher growth rate after it emerges from recession?

Notes

1. See, for example: Norton, R. D. Industrial policy and American renewal. *Journal of Economic Literature*, March 1986, pp. 1-43.
2. Department of Trade and Industry. *DTI: the Department for Enterprise*. London, January 1988, p. 41.
3. Apart from the sheer volume of policy changes, this reflects both the author's judgement about what the major measures have been and his experience, which has concentrated on manufacturing.
4. For 1984 election policy, see: New Zealand Labour Party. *1984 Policy Document*. Wellington, 1985, pp. 44-46, 88-90. The 1987 Labour election policy statements can be found in a series of documents, including •*The Economy: Labour's plan for the future*, Wellington, 1987; •*The Regions: towards 2000 - building on our strengths*, Wellington, 1987.

5. Organisation for Economic Cooperation and Development. *OECD Economic Surveys 1986/87, New Zealand.* Paris, May 1987, pp. 8-9.
6. Ibid, p. 58.
7. See, for instance: Hawke, G. *New Initiatives for the New Zealand Economy.* Speech to National Business Conference, Dunedin, 9 April 1987, p. 1.
8. Blades, D. & Roberts D. A note on the new OECD benchmark purchasing power parities for 1985. *OECD Economic Studies*, No. 9, Autumn 1987.
9. Baumol, W. J., Panzar, J. C. & Willig, R. D. *Contestable Markets and the Theory of Industry Structure.* New York, Harcourt Brace and Jovanovich, 1982.
10. See Wooding, P. Liberalising the international trade regime. *In:* A. Bollard and R. Buckle (Eds.). *Economic Liberalisation in New Zealand.* Wellington, Allen and Unwin/Port Nicholson Press, 1988. This provides a detailed account of the development of licensing, tarrifs and export incentives.
11. Templeton, H. *Philosophies, Objectives, Strategies.* Wellington, Department of Trade and Industry, 9 November 1983.
12. The industries studied included shipbuilding, general rubber, ceramics, glass, electric motors, tyres, electronics, motor vehicle assembly and components, carpet, plastics, footwear, textiles, apparel, writing instruments, tobacco, wine, starch and canned fruit.
13. Wooding, P., op. cit.
14. Department of Trade and Industry. *Tariff Working Party Report to the Minister of Trade and Industry.* Wellington, 1987.
15. Syntec Economic Services. *The Structure of Industry Assistance in New Zealand: an exploratory analysis.* Wellington, the Treasury, 1984.
16. Taylor, M. C. & Hayes, J. L. *Assistance to Pastoral Agriculture 1983-84 to 1986-87.* Wellington, Economic Policy Service, MAF Corporation, 1987. The effective estimates (ERAs) take into account the costs imposed by assistance to other industries. Taylor and Hayes assumed agriculture faces a cost excess of 20 percent, which is probably too high.
17. Ibid.
18. Vautier, K. M. Competition policy and competition law in New Zealand. *In:* A. Bollard and R. Buckle, op. cit.
19. Public funding in New Zealand is around 46 percent, with 18 percent spent in universities compared to OECD averages of 16 percent and 18 percent respectively. (Cited in: Bollard, A. & Harper, D. with Theron, M. *Research and Development in New Zealand: a public policy framework.* Wellington, New Zealand Institute of Economic Research, 1987, p. 89.)
20. Beattie, D. *Key to Prosperity: science and technology.* Report to the Ministerial Working Party, Wellington, December 1986.
21. Levine, M. E. Airline competition in deregulated markets: theory, firm strategy and public policy. *Yale Journal on Regulation*, Spring 1987, p. 394.
22. Ministry of Agriculture and Fisheries. *Situation and Outlook for New Zealand Agriculture*, April 1987, pp. 28, 31.
23. New Zealand Meat and Wool Boards' Economic Service. *Annual Review of the New Zealand Sheep and Beef Industry 1986-87*, August 1987, p. 14.
24. Ministry of Agriculture and Fisheries, op. cit., p. 45.

25. Ibid, p. 57.
26. New Zealand Meat and Wool Boards' Economic Service, op. cit., p. 35.
27. Ibid, p. 10.
28. Ministry of Agriculture and Fisheries, op. cit., p. 16.
29. Survey by Market Research NZ Ltd. *National Business Review*, February 2, 1988, p. 3.
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33. Clements, R., op. cit.
34. See: Staley, H. with Bravenboer, T., Fletchers, A. & Murrin, P. *Follow Up Survey of Manufacturers' Responses to Economic Policy Changes Following the 1984 General Election*. Department of Trade and Industry, 1988, p. 10.
35. Ibid. p. 13.
36. •Ibid; •Roseveare, D. et al., op. cit; •Galt, D., *Adjustment to Change in New Zealand Manufacturing*, Wellington, Department of Trade and Industry, 1986.
37. Galt, D., op. cit., provides manufacturing investment statistics on this basis.
38. See, for instance, Savage, J., *Economic Liberalisation and the Outlook for Manufacturing*, Wellington, NZIER, 1986, which touches on these issues.
39. Department of Statistics. *The New Zealand Labour Force*. Wellington, September 1987 Quarter, p. 40.

Chapter 9

REFORM OF THE LABOUR MARKET*

Penelope J. Brook

THE LIVING STANDARDS THAT MOST people can achieve, and the satisfaction that they can derive in the process, depend directly on their access to employment. The welfare of society as a whole similarly depends on the capacity of its citizens to put their labour to its most highly valued uses. Individual happiness, and much of the success of the economy as a whole, therefore depends on the ease with which workers can enter and leave the labour force and move within it.

Even in a static environment, a major role of government is to foster a regulatory framework in which people wishing to sell their labour can do so most advantageously to them and the community as a whole. Where economic circumstances are changing, the efficiency or flexibility of the labour market is even more important. The success of the economy in reacting to change (and the equity with which the benefits and burdens of change are distributed) depends on its capacity to mobilise all its resources, including labour, innovatively and efficiently.

In New Zealand, a characteristic reaction to change has been to resist it by increasing the degree of government intervention in the economy. This is a process which feeds on itself, as individual sectors seek protection to counterbalance the special treatment of other sectors. The result is a complex system of income transfers between sectors (often related to the strength of individual lobby groups). Incentives for the economy to adjust to change are reduced or obliterated.

Since 1984 (and in some respects since the late 1970s), there has been a reassessment in New Zealand of the case for, and appropriate design of, intervention in most areas of the economy. The labour market is the area in which this reform has been least ambitious. Two reasons may be offered for this. First, both political parties have seen substantial difficulties in changing the pattern of interven-

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tion. The Labour Party has a close historical relationship with the labour movement, but few initiatives were taken by the previous National Government and, in opposition, the National Party has been critical of the Govenment's state sector reform. Secondly, there is a widespread belief that labour relations involve inherent conflict between employers and employees, and that, in labour markets, the objectives of efficiency and equity are diametrically opposed. A relatively free market is seen as against the interests of vulnerable members of the workforce.

The changes that have been made to private sector industrial relations legislation since 1984 have not challenged these beliefs. Both producers and their employees have been limited in their capacity to adjust to market forces elsewhere in the economy, generating considerable increases in unemployment. There is a clear need to give priority to reforming the labour market.

The potential for a society to direct its scarce resources, including labour, to their most valued uses rests on the capacity of its markets to adjust on the basis of new information. Processing information is facilitated by competition through the use of markets. Competition is an evolutionary process rather than an end state. The efficiency of markets in processing information and directing resources depends on their flexibility.

Flexibility is not an end in itself. Nor is the flexibility of the labour market of greater importance than the flexibility of other markets, although it is arguably more difficult to achieve (because of high "sunk" costs in education, housing and the like). It is, however, critical in determining how well other markets function. As the Organisation for Economic Cooperation and Development's Dahrendorf Report noted:

> Labour markets are an important for the growth process itself; as the level of economic activity increases, they function better, and as they function better, the level of economic activity increases further. . . . [F]lexibility then serves not only the processes of adjustment, but also innovation, equity and a higher quality of life . . . In this sense, labour market flexibility is a key to both economic efficiency and social progress.[1]

The degree of flexibility of a labour market will be reflected in the capacity of individual workers to maximise the returns (both pecuniary and non-pecuniary) to their labour through their ability to move between or within firms and industries, and to negotiate or participate in contracts that secure the conditions of pay and work they desire. On the part of employers, it will be reflected in their capacity to negotiate contracts that will attract and retain employees of a desired quality, and deploy them in the most productive way. Most simply, then, it involves the ability of employers and employees to negotiate mutually advantageous contracts and to adapt these contracts as circumstances change, and the ability of workers to move within and between companies.

The central concern of this chapter is with the mechanisms through which labour contracts can be made and enforced. The following section describes the evolution of the private sector system in New Zealand, and the nature of changes since 1984. In the third section, the more radical changes in the public sector are set out. In the fourth section, the chief elements of the system are discussed by reference to the institutions and practices that might be expected to arise in a relatively free labour market. The final section considers the case for labour market reform in the context of broader economic reforms.

The structure of labour contracting, or labour relations, is not the only matter of concern in an evaluation of the labour market. Education, immigration, equality of opportunity, the tax structure, the system of unemployment benefits and the broad impact of fiscal policy are all critical.

The importance of policy in these other areas is not contested. But the success of policies aimed, *inter alia*, at providing a well-educated and relevantly trained workforce, ensuring that women or minorities are not disadvantaged in employment, and providing incentives to seek work and adequate relief for those unable to find work is, in the end, dependent on how well the market itself functions. In a poorly functioning market, workers' capacity to find employment that uses and rewards their skills will be reduced, no matter how well educated they are. Signals to the education system about the kinds of skills needed will be unclear or distorted. Equality of opportunity is likely to be better served in a properly functioning labour market: greater mobility of workers (and lower overall unemployment) will reduce employers' capacity to discriminate according to economically irrelevant characteristics. The provision of a flexible and efficiently operating labour market may be seen as a first step towards clarifying the need for other labour market policies, and raising the subsequent chances of their success.

1. REGULATION IN THE NEW ZEALAND LABOUR MARKET

Union activity in New Zealand dates as far back as the 1850s. Industrial relations legislation, however, began with the passage of the Industrial Conciliation and Arbitration Act in 1894. Pressure for the legislation arose both from the events that surrounded the maritime strike of 1890, and from demands for greater protection of workers, many of whom were geographically immobile. While there have since been frequent modifications to the law governing the operation of labour markets, notably the introduction of compulsory unionism in 1936 and the consolidation of policy under the Industrial Relations Act 1973, the principles and procedures set out in the 1894 legislation have in essence been retained.

The central feature of this system is its provision for national, occupation- or craft-based awards setting out minimum wages and conditions. This award system is supported by union registration procedures and the legal imposition of blanket coverage for awards negotiated by registered unions. Both the negotiation of awards and the resolution of disagreements about their interpretation are handled through a state-run conciliation and arbitration process.

The registration system was designed to promote the formation of unions and minimise demarcation disputes amongst them. Registration confers on a union the exclusive right to represent all those workers "conveniently covered" by it, and to require the negotiation of an award on their behalf. Registration is mainly on an occupational or craft basis, so that a single union can represent workers across a range of firms and industries. A single employer is likely to be required to negotiate with more than one union. Registration is not compulsory, but is heavily favoured – agreements secured by unregistered collectives of workers are not legally binding.

While, technically, the purpose of registration is to subject unions and their membership to the provisions of industrial relations legislation, its primary economic effect is to confer quasi-monopoly status on existing unions. This is reinforced by access to a balloting procedure by which a compulsory union membership clause can be enforced in awards and collective agreements (thus compelling employers to deal solely with union members). Further, the definition of "convenient coverage" has meant that there is a low rate of new union formation.

On the other hand, union amalgamation is not uncommon, and has been reinforced by the stipulation in 1987 legislation that a minimum membership of 1,000 serve as a prerequisite for registration. Overall, the registration system thus makes it difficult for discontented workers either to change unions or to establish new unions so as to achieve labour contracts more beneficial to them.

The unique position afforded unions has made for a complex web of legislation stipulating acceptable union objectives, codes of internal management and, more generally, constraints on union activities and on the negotiation process. These attempts to prevent abuses of union power and to protect their members or prospective members from bad administration or victimisation are "necessary" primarily as a means of compensating by legislation for strong restrictions on employees' ability to opt out of the union system. (In this they may be compared with the relatively light legislative requirements imposed on organisations, such as incorporated societies, from which members are free to disassociate themselves.)

In 1983, the National administration introduced voluntary unionism.[2] This resulted in some moves by unions to broaden their activities - for example, by setting up medical centres and health schemes - in order to retain members. Reductions in membership were not widespread, although there were drops among retail trades and clerical workers. In accordance with election promises by the Labour Party, compulsory unionism was reintroduced in 1985. There was little attempt to justify it as a measure that was consistent with the Government's general deregulatory programme.

The awards that registered unions negotiate cover by law all relevant employers and employees, whether or not they are parties to the negotiation process. This is referred to as "blanket coverage". Awards effectively establish minimum wages and working conditions, but are backed by the government policy on minimum wages, working hours, occupational licensing, health and safety, maternity and paternity leave, equal pay and the like.[3] Negotiated minima typically exceed the levels stipulated by government[4]; government minima may be seen as a statutory floor for those not covered by union negotiations.

To give some flexibility to the system, there was from 1973 to 1987 provision for "second-tier" bargaining at a sub-national level. However, there was little room for secondary agreements to adjust negotiated awards downwards. Further, the extent to which employers were prepared to use them was limited by the tendency for the results of sub-national bargaining to be fed back into the national award system, in particular inflating the wage settlements considered acceptable by unions. From 1980, there was also provision for composite agreements, in which a number of unions could negotiate a package with an employer which would supersede individual national awards. This was seen as a means of facilitating enterprise bargaining.

Negotiation between employers and unions can only be initiated by the creation of a "dispute" characterised either as a dispute of interest (matters of wages and conditions) or as a dispute of rights (matters of the interpretation of awards and agreements, and personal grievances). This terminology, and that of the process which follows, reflects the underlying assumption that employer-employee relations are essentially antagonistic. Certainly, the notion of interest dispute has little place in more orthodox contractual agreements.

The creation of a dispute opens a process of conciliation, drawing on a state-provided conciliation and mediation service. Until 1984, where agreement could not be reached through conciliation, either party could take the dispute to the Arbitration Court. This was a specialist court, initially intended to minimise unions' recourse to direct action in support of claims.

The New Zealand economy has nevertheless been particularly prone to strikes[5], and this reflects the relative weakness of the

Arbitration Court (which has not been used for significant arbitration on wages, outside general wage orders, since the 1968 nil wage order). More importantly, it illustrates the role of the current system in perpetuating an adversarial form of industrial relations, and limiting the scope for bargaining in individual workplaces to reach solutions to problems that are not national or occupational in nature.

Until the early 1970s, the Government had little direct role in the bargaining process (although there are individual examples of intervention). This changed in the more inflationary environment of the 1970s, in particular through the imposition of wage controls. In periods in which controls did not apply, there evolved a pattern of wage rounds in which awards across unions would reflect the results of major "trend-setting" negotiations. This was reinforced by the increasing rigidity of relativities between occupational awards. This adherence to relativities was an important means of escaping the uneven impact of the periodic imposition of wage controls. It was a practice reinforced by employers, for whom the support of uniform wage rounds was a damage-minimising response to their incapacity to negotiate settlements tailored to particular situations (this was also reflected in their delegation of responsibility for negotiations to employers' organisations).

The importance of relativities remained under a move towards tripartite wage-fixing, involving government, employers and unions, in the early 1980s. Between 1981 and 1984, the long-term wage-fixing conference was used to discuss the possibility of a negotiated wage/tax trade-off. This conference was replaced, after the change in government in 1984, by the Tripartite Wage Conference. This has become primarily a vehicle for communication by the Government of its assessment of the state of the economy. The period since 1984 has been notable for the absence of a direct presence by the Minister of Labour in the wage-bargaining process, although the nature of the system facilitates indirect government influence.

Major Developments Since 1984

After the change in government, an economic summit was organised as a forum for debate on the future direction of economic policy. There was general agreement by unions and employers on the need for greater flexibility in the labour markets and, in particular, for an increase in industry and enterprise bargaining. For example, a union paper to the summit stated that, "[T]he unions would like to see the old system modified so that more consideration could be given to factors that were specific to an industry or occupation, and a good deal less to entrenched relativities."[8]

There was thus a clear mandate for changes in labour market regulation. A limited package of reforms was introduced later in the year, its main components being the reintroduction of compulsory unionism, the institution of the Tripartite Wage Conference, modification of the criteria to be used by the Arbitration Court (with the emphasis in determining wage levels shifting from relativities to supply and demand conditions) and a change from compulsory to voluntary arbitration (so that recourse to the Arbitration Court required the consent of both the union and the employer). The abolition of compulsory arbitration has served to reinforce the declining use of the state apparatus for arbitration. Since a finding by the more recently established Labour Court that a company's ability to pay is not a criterion to be considered in arbitration, the interest of employers in using the process has been further reduced.

In late 1985, the Government initiated a general review of labour relations legislation on the basis that changes in other areas of economic policy required a more thorough consideration of labour market regulation. This process was guided by a green paper[7] which posed questions on the full range of existing legislation, with the exception of compulsory unionism. However, the paper lacked a clear analytical framework, and failed to question the principles and objectives underlying the legislation. The ensuing debate was highly politicised. The legislative review lasted eighteen months, with submissions on the green paper, the announcement of a set of policy decisions, the formulation of a new labour relations bill and submissions to the parliamentary labour select committee. However, adherence to the objectives and procedures of the existing legislation meant that the resulting Labour Relations Act 1987 brought little increase in the flexibility of the system.

Under the 1987 Act, compulsory unionism was retained. Provision was made for a ballot on its retention to be carried out once in every three award rounds. Responsibility for enforcement was shifted from employers to unions. (There are indications that the costs of enforcement, particularly outside the main cities, are leading to a fall in union membership.) Restricted provision was made for changes in union coverage, but the right to initiate changes was confined to existing unions. These provisions have not been used (perhaps in part because of a Federation of Labour resolution against their use). To the extent that their use has been considered, it has brought renewed attention to conflicts of interest over demarcation. The minimum membership size of unions was raised to 1,000, ostensibly as a means of ensuring that unions were not too small to exercise "bargaining power". This has generated a process of amalgamation of smaller unions. Amalgamation has often taken the form of loose affiliations of unions, on a political basis rather than according to involvement with common employers. It has not, on the whole, reduced the number of unions with which an individual employer must negotiate. Both the minimum membership level and the tendency for union amalgamation to be political rather than industry-based work against the achievement of enterprise bargaining.

The Act also introduced changes to the nature of agreements which could be made outside the award system, thus removing second-tier arrangements and substituting a provision requiring that employers be "cited out" of awards where unions wish to negotiate separate, legally binding, renewable agreements. This "either/or" approach generates some independence between high extra-award settlements and the wages and conditions in awards negotiated in successive wage rounds, thereby potentially removing one of the problems associated wiih second-tier arrangements. Also, this approach was expected to facilitate enterprise bargaining, in that the case for a separate agreement does not need to be renegotiated each wage round. However, the development of separate agreements is constrained by the right to cite an employer out of an award being restricted to the union involved; employers cannot choose whether they will be subject to an award.

The provision for second-tier bargaining in previous legislation was generally considered by employers inferior to the inclusion of pass-on provisions in awards (so that employers paying above award rates could automatically pass on to their employees increases negotiated in award rates). The continuing availability of pass-on provisions reduces the incentive on the part of both unions and employers to use separate agreements, or to move to enterprise or workplace bargaining. There have also been minor changes in the arrangements surrounding composite agreements, in particular that they must be fully renegotiated upon expiry. However, they can still, at union instigation, be negotiated on top of an award.

The Act also brought changes in the mechanisms for reaching and enforcing awards and agreements. The distinction between conciliation and mediation was removed, and the Arbitration Court was split into an Arbitration Commission, which acts as an industrial body to consider disputes of interest, and a Labour Court, which deals with legal matters arising from labour disputes, demarcation disputes and personal grievances. The use of a mediator employed by the Department of Labour continues to be required for award negotiations, but private mediators can be used in the negotiation of agreements.

The period since the implementation of the 1987 Act has seen some changes in the nature of awards and agreements negotiated. It is unclear how far these reflect changes in the legislation rather than changes in general economic conditions. The 1987/88 wage round was the first to be conducted under the new provisions. Prominent events in the round included an agreement negotiated by the Engineers' Union and employers to dismantle the Metal Trades Award into narrower awards that could be seen as a basis for future enterprise or industry agreements (though this has yet to come to fruition), and the division of the Drivers' Award into three separate components. Negotiation of a "Japanese-style" composite arrangement by Mitsubishi, and agreement to a similar arrangement by part of the Nissan workforce, received much attention. Both arrangements would have been possible, however, under the previous legislation, and therefore may be partially attributed to changes in broader economic conditions.

There were very few cases of employers being cited out of awards who were not previously involved in some form of voluntary or composite agreement. The rigidity that arises from the inability of employers to opt out of the award system was clearly indicated in the meat industry, and also in the case of Independent Newspapers Limited (INL). In the latter case, the refusal of the national printers' union to accept an agreement negotiated between the company and its workers covering the introduction of new printing technology led to a strike against the union by the workers involved. No use was made of the provision for changes in union representation.

The events of the 1988/89 wage round reinforce the impressions created by the 1987/88 round. While there has been some progress in reducing restrictive practices and negotiating trade-offs between wage increases and changes in work rules, these moves towards greater flexibility, along with attempts to decentralise the bargaining process, have met with strong union resistance. Wage adjustments have been relatively insensitive to regional and industry circumstances and to the generalised spread of unemployment.

Overall, there is no clear evidence that the new legislation is proving successful in allowing rapid evolution of the labour relations system. It does not appear to be accelerating moves towards enterprise or workplace agreements. There effectively remains an industrial relations system in which employers must often negotiate with several different unions, and in which awards negotiated by (increasingly concentrated) unions on the whole apply uniformly across industries and regions. The overall impact is reinforced by the maintenance of generally rigid relativities between awards.

2. Reform in the Public Sector

The changes made since 1984 to the private sector labour market may usefully be compared with changes introduced for the public sector (which accounts for approximately 25 percent of the labour force). While a number of changes to public sector arrangements have been justified as reducing inconsistencies with the private sector system, reforms in the public sector have been more far-reaching than those in the private sector, and in this may be regarded as setting a pattern for the latter.

The establishment of the terms of labour contracts in the public sector is complicated by the absence of commercial pressure on government departments as employers. Wages have typically been fixed by reference to relativities between the public sector and the private sector where similar jobs appear in both, and within the public sector where no direct comparison with the private sector is possible. Higher salaries are determined by a separate commission. There are inevitably problems in creating incentives for the efficient deployment of labour and for employee performance. Performance incentives have been limited by the security of state sector employment and the prevalence of promotion on the basis of duration of service, rather than merit. Incentives have been further diluted by the breadth of state union coverage and neogitations,[a] and the use of annual general wage adjustments between less frequent reviews of particular categories of wage movements in the private sector.

The system of employee representation has differed fundamentally from the private sector in that registration has not been a prerequisite for official recognition of unions. Agreements and union membership, at least in some instances, are voluntary. However, the terms of public sector agreements have been more subject to direct intervention in that they have been seen as illustrating "acceptable" terms and conditions to the private sector (for example, with regard to equal pay and the rights of women and minorities).

The move to corporatise some areas of state activity through the creation of state-owned enterprises (SOEs) has subjected these activities to more direct competitive pressure, creating a need for greater flexibility in employment contracts. The re-evaluation of the activities of the rest of the rest of the public sector, and a concern to increase the efficiency of their operation, have brought renewed attention to state personnel policy and industrial relations.

Provisions to enable enterprise bargaining in SOEs were included in the SOE legislation which came into effect in April 1987. Changes to state sector pay-fixing mechanisms were released around the same time, and related draft legislation was introduced to Parliament at the end of 1987. Despite widespread opposition from state sector unions, the legislation was passed with minor modifications in March 1988. Public sector arrangements were made to parallel the private sector,[a] for example by applying union registration mechanisms to the public sector and abolishing the special appeals procedure.

To increase accountability, heads of departments have been replaced with chief executives, appointed by the State Services Commission (with a ministerial right of veto) for a maximum of five years, and responsible for all other appointments within the department. The flexibility of arrangements possible in the public sector is arguably greater than that in the private sector. In particular, there are more explicit moves in the direction of enterprise bargaining, both through the arrangements for SOEs and through a move (advocated by the Public Service Association) to department-by-department agreements. Also, automatic general wage adjustments have been abolished. Under the tight budgetary constraints imposed by the 1988 Budget, this decentralisation has arguably facilitated agreements that demonstrate a clearer recognition of a trade-off between wages and jobs.

These reforms are an attempt to overcome in the public sector some of the deficiencies that are present in the private sector arrangements. They do not, however, question the fundamental nature of the private sector system. In both sectors, then, a case may be argued for further reform.

3. Labour Market Regulations: An Assessment

An assessment of the impact of elements of New Zealand's system of labour market regulations may be made by comparing them with the institutions that might arise in a situation less constrained by historical labour market regulation. Such a benchmark would take account of uncertainty and uneven information, but labour market regulation might be restricted to defining and enforcing property rights in labour and maintaining a law of contract. The essential difference between current practice and such a system is that, whereas the former is directive, specifying how workers may organise, who may be party to employment negotiations and how they may enforce the results of their negotiations, the latter would be facilitative, seeking only to establish such rights and systems of contractual law as would enable employees and employers to determine the nature of their relationship in the most mutually beneficial way.

The simplest form of employment contract is that made between a single employer and a single employee. The enormous variety in the nature of labour services and in the conditions under which they are used, and similar variety in workers' preferences, means that the detail of contracts will ideally vary widely. Were it not costly to discover all relevant information about workers and jobs, we might expect a highly detailed contract for each worker in each job, setting out precise terms and conditions, and perfectly protecting both the worker and the employer. Such a process is impractical, so that in many cases it is most efficient to use uniform contractual forms, and to deal in contracts with only a small number of possible contingencies.

In any employment situation, there may be advantages in employing collective bargaining to reduce the overall cost of establishing mutually satisfactory wages and conditions. Where the number of similar workers is large, or where the information relevant to the bargaining process is complex, bargaining may be delegated to an agent. Even where workers perform dissimilar tasks, there may be an advantage in collective (and delegated) bargaining on the basis of features that they have in common. An important case of this will be where they are all employed by the same firm, on whose fortunes they are all to some extent dependent. In such cases, the creation of a union can be an efficient response to the cost of processing information relevant to an employment contract, and negotiating and monitoring the enforcement of that contract.

There are, of course, costs beyond the administrative to such collective and delegated bargaining. To the extent that collective bargaining results in a wage that represents an average of the values of worker inputs, exceptional workers will be penalised, and a disincentive to effort may be created. The former problem may be resolved by individual negotiations for truly exceptional workers, for whom there will be an incentive to opt out of collective bargaining if the expected benefits are greater than the costs of individual bargaining. In small groups disincentives may be reduced by mutual monitoring, while in larger groups it may be handled through the employment of supervisors, but some residual cost is likely to remain. Employers might also be expected to have an interest in bargaining with groups of employees rather than individuals – again "sacrificing" the possible productivity gains to be had from tailoring contracts to provide incentives in return for the reduced costs of a single negotiation process.

The decision to delegate bargaining to an agent, whether by employers, by employees or by both, will similarly depend on an analysis of costs and benefits. The benefits associated with the use of specialists to process information and carry out negotiations will be set against the costs of an agent failing to represent the true interests of his or her party. The balance may be tipped in favour of unionism if the unions are able to supply other services, such as education, pension schemes or medical centres.

Where workers can freely associate, unions are likely to arise as a means of reducing the costs of negotiating and enforcing labour contracts. Their coverage is likely to be incomplete, and the nature of their coverage to be non-uniform – some will cater for a group of workers in a workplace, others an entire workplace, and still others a particular kind of worker across a number of different workplaces. The nature of participation in negotiation, and the nature of contracts negotiated, may also vary. In so far as workers are free to join and leave collective groupings (subject to such conditions as those groups might set out), such differences may be argued to be unimportant in terms of the welfare of workers.

It is reasonable to ask whether any benefit is gained by conferring on unions an exclusive right to negotiate on behalf of workers, and by reinforcing this through statutory compulsory union membership.

Associated with this are more specific questions as to the impact of national occupation-based unions, and centralised structures for negotiating and overseeing the enforcement of awards. More fundamentally, it may be asked whether the New Zealand system affords better protection to workers than a less regulated system.

These questions are all the more relevant in that the present system is substantially unique to New Zealand. In other developed countries (whose performance has well outstripped that of New Zealand), collective bargaining is predominantly at a firm or workplace level, and non-unionised employment is increasing. In New Zealand, as overseas, the service sector, where uniform collective agreements make less sense than in, for example, manufacturing, has been growing relative to other sectors. Increasing participation in the workforce by women has led to demands for more flexible conditions of employment. The quest for improvements in efficiency has led increasingly to contracts with direct incentives to effort, and improved solutions to monitoring problems (for example, through the use of independent contractors). Self-employment has also grown. In countries where the labour market is less regulated than in New Zealand, unions have either adapted to accommodate these changes or have become less important.

Registered Unions and Compulsory Unionism

An important negative effect of giving unions an exclusive right to negotiate with employers, and thus restraining the formation of new unions or other forms of worker representation, is the reduction of direct communication between an employer and his or her employees, leading to an emphasis on average rewards and the associated reduction of incentives to effort. As commentators on labour relations in the United States have argued:

> While it is often true that unions are more likely to be successful against a backdrop of poor employer-employee communications, it is more often true that the advent of unionisation not only freezes that condition but also acts to prevent any significant improvements.[18]

The inability of employers and employees to negotiate other than through the recognised union reduces both understanding and the ability to tailor contracts to particular needs and capabilities, or to resolve conflicts that arise from differences in workers' abilities and preferences. It also reduces the capacity of the firm to respond innovatively and rapidly to change. Such a response depends rather on the establishment of a degree of trust in workplace relationships that is quite at odds with the current adversarial cast of industrial relations.

The exclusive right of unions to negotiate on behalf of workers is balanced by legislatively imposed duties, and by the nature of their responsibility to their membership. Because of severe restraints on workers' ability to change their union representation, the prescribed arrangements for union conduct are far in excess of the legislative duties placed on organisations from which members can freely dissociate themselves. Quite apart from the resulting burden of administrative and compliance costs, this situation may restrict the efficiency of the bargaining process. In New Zealand, limits have, in the past, been imposed on the matters on which unions can negotiate (these limits were removed in the 1987 legislation), and there continue to be restrictions on the structure of bargaining. There have also been restrictions on union subscriptions – a necessary safeguard where membership is compulsory, but one which limits the capacity of unions to expand in ways that might be considered desirable by a voluntary membership. While union leaders are typically seen as the principal beneficiaries of a highly regulated labour market, they might benefit from a reduction in this kind of regulation. The freedom to define the range and price of their activities (subject to their ability to attract members) could compensate for any loss of political power.

The use of national, occupation- and craft-based unions may be seen as reinforcing the problems associated with the registration process. The distance that centralisation necessarily establishes between the union leaders and the workers they represent makes it more difficult for leaders to keep informed about individual situations, and their capacity to represent the particular needs of workers in diverse circumstances is reduced. This makes it particularly difficult to define quite what leadership should be held accountable for, let alone to hold it accountable. Ironically, some of the smaller unions being eliminated by the minimum size requirement were regarded as being among the more democratic and efficient. The significance of agency problems is reflected in the INL printers' case, described above. It is also clear in the case, recently investigated by the Human Rights Commission, of a group of Air New Zealand air hostesses whose aspirations for promotion were frustrated not only by their employer but also by their (male-dominated) union.

The dominant role of occupation-based unions may also be seen as raising the costs of negotiation to employers. They are required to negotiate, in sequence, with a number of unions. The difficulty of calculating labour costs makes planning more difficult for employers, and raises negotiation and enforcement costs. (While the maintenance of wage relativities increases the uniformity of results of the negotiating process, it probably does little to decrease transaction costs.) The consequent delegation of wage bargaining to employer representatives is not surprising. However, such delegation has adverse implications both for the character of individual workplaces (if anything, reinforcing the adversarial perception of the employment relationship) and for productivity, in that the scope for creative responses to both technical and contractual problems is reduced.

A system characterised by large unions with considerable monopoly power is also likely to affect the contractual form of employment relationships. Employers and workers unwilling to have their relationship determined by a national occupational award will be limited in their capacity to work out a "normal" employment relationship outside the scope of the award. This encourages the use of outside contracts to an extent that would not occur were internal labour contracts freely determined. Union opposition in New Zealand to the exemption from awards of labour-only contractors and of so-called "dependent" contractors (those contracting substantially to a single employer) may be seen as an attempt to close this gap in union coverage. In a freer market, the range of contractual types occurring might be broader, and the rigid distinction between internal employment and external contracts might be expected to break down. While union coverage would be more likely for conventional employment contracts, there is no a priori reason why external contractors should not also act collectively.

A precondition for a more equitable and efficient system of contracting is that workers be able to choose the kind of union representation most appropriate to their needs. In many cases, the chosen form would be an enterprise or workplace union; the desirability of such unions has already been publicly recognised by union leaders and appears to have strong public support.[11] In countries such as Japan and Switzerland, where the labour market is less regulated, there has been a shift away from craft-based to company-based unions. This suggests that workers have come to identify themselves more closely with the interests of other workers in the same company, and with the company as a whole, than with more traditional occupation-based guilds. "Multi-skilling" has accompanied this shift. Where labour contracts are negotiated on a workplace or company rather than a national basis, there is more scope for them to be tailored to provide productivity incentives to workers; the returns to employment are thereby linked more directly to the fortunes of the company (through, for example, share ownership schemes). The attraction of enterprise contracts in New Zealand is reflected in the move to break down some national agreements, despite the cumbersome nature of regulation currently governing such a process.

The form of union that arises should not be a matter of government interest, but only of employee and employer interest. Government may mandate a procedure by which workers can elect union coverage (for example, through workplace ballots); its subsequent role should be to ensure that unions conduct their affairs democratically, are answerable to their members and are accountable for their use of funds. Government would also have a role in ensuring that unions have the legal status necessary to make binding contracts on behalf of their members. Current constraints on representation would not be required, and the entire issue of demarcation would be removed.

The problems discussed so far arise apart from compulsory unionism. Compulsory unionism reinforces a rigidity that already exists through the registration process and the resulting monopoly power of unions. This power operates in two directions. First, the union is the sole "licensed" seller of negotiation services to employees (employees' right to negotiate on their own behalf being severely constrained). Second, the union, endowed with comprehensive monopoly power by compulsory unionism, is the sole effective seller of labour to employers.

A common argument in favour of compulsory unionism has been that it removes the potential for non-members to "free-ride" on union-negotiated agreements. (The importance of this is closely linked to unions' exclusive right to represent their members.) However, benefits to non-members will not always necessarily exceed the spillover costs. In particular, non-members may find that the benefits from union coverage are of limited value for them because of the uniformity of wages and conditions negotiated by the unions.

The magnitude of the free-riding problem is likely to depend on the size of the union involved. It will be greater in a system of registered, national, predominantly craft-based unions than in a system where the basis of union coverage could be freely decided by workers. In the latter case, there will be more incentive to participate directly in union activities, since there will be a greater capacity to make the union represent the particular interests of workers. The benefits of membership in terms of reduced costs of negotiating and enforcing contracts are likely to be less diluted by agency problems between workers and their union.

The Content of Awards and the Scope of Negotiation

Where bargaining between unions and employers is on a workplace or some other relatively narrow basis, it may be expected that the wages and conditions negotiated will be broadly appropriate to the situations of the firms involved and the productivity of their employees.[12] The broader the basis of bargaining, the lower will be the capacity to deal effectively with differing work situations. Broadly based unions – like any collective negotiators – will seek remuneration and conditions appropriate to the average productivity of the workers whom they represent and the "average situation" of the employers with whom they are negotiating. The levels agreed will differ from those that would be set by more disaggregated bargaining.

This kind of averaging imposes significant constraints on firms or groups of workers where the appropriate settlement is below the national average. Firms that "cannot afford" the nationally negotiated wage (or which cannot afford to implement nationally negotiated minimum conditions, or for which these conditions are inappropriate) may be obliged to lay off workers rather than negotiate lower settlements or different conditions. This disinvestment has significant long-term consequences and can exacerbate regional problems and the social costs of adjusting to economic change.[13] Workers whose productivity does not justify the level of remuneration negotiated centrally will find themselves priced out of the market.

Minimum wages, in particular, have been found to have a disproportionate effect on young and unskilled workers, on workers re-entering the workforce, on those who have been "de-skilled" by long-term unemployment and on minority groups already disadvantaged by lower access to education and training. By entrenching the unionised negotiation system with statutory provisions on minimum wages, working hours, holidays and the like, the government reduces the chances of workers priced out of unionised parts of the labour market of finding other employment.

The New Zealand system has penalised not only firms and workers at the lower end of the market, reinforcing the costs of structural change in terms of increased unemployment, but also firms and workers whose performance is, at least potentially, above the average. When the system provided for second-tier bargaining to supplement or replace nationally negotiated minima, the concern that above-award settlements would feed back into subsequent national awards reduced employer enthusiasm for their use. The use of separate agreements made possible by the 1987 legislation is limited by the fact that employers cannot initiate such agreements. The availability of pass-on memoranda, while facilitating the payment and perpetuation of above-award rates, limits the incentive to develop more flexible arrangements among less innovative unions and employers. Firms that stand to benefit from structural change are limited in their capacity to offer packages that will attract workers away from other firms, while for above-average workers there may be little means of improving their remuneration other than relocation or emigration. Constraints on the upward flexibility of settlements can also be an important disincentive to pursue costly education and training. Thus, while nationally negotiated awards are likely to be most binding on the wages and conditions available to below-average workers and firms, they also impose important constraints on firms and workers with the potential to perform above the average. Both effects limit severely the ability of workers and firms to accommodate and instigate economic change.

The hypothesis that a prime motivation for union formation is the information and other transaction costs associated with the creation and enforcement of contracts also casts light on the New Zealand system of award negotiation, enforcement and review through state structures for mediation, conciliation and arbitration. In the course of the activities of freely formed and operating unions (and in the negotiation and enforcement of individual employment contracts), mediation and arbitration are both likely to arise. It is likely that specialist agencies will evolve to provide these services. The use of such services is likely to be a preferred alternative to recourse to the civil courts because of the specialised nature of the issues, and because negotiation is a more rapid means of resolving disputes. It may then be asked whether there is a net benefit to state involvement either in regulating mediation and arbitration, or in participating in this process directly, through government agencies or direct intervention in negotiations. While it is unclear a priori whether there is a case for legal constraints on labour market contracting which are more extensive than for other types of contract, there is little apparent justification for direct government involvement in the negotiation process.

The complex and unwieldy system of contract negotiation and enforcement that has developed in New Zealand, initially justified on the basis of the disadvantages faced by employees in bargaining situations which were thought to be inherently uneven (and adversarial), may be regarded in large part as a corequisite of the registration of unions and blanket coverage of awards. The system establishes safeguards that would be unnecessary were unions not legally endowed with monopoly power. There would be less need to attempt to enforce procedures "fair" to employees if they had the freedom to dissociate themselves from unions, or to create specific protections for employers. The cumbersome nature of the system may render these attempts somewhat self-defeating, creating an incentive to use rules of thumb (such as the relativities system) and to use strike action to lend immediacy to claims and their resolution.

Streamlining of the conciliation and arbitration system, as attempted in the 1987 legislation, may reduce costs and so yield more socially desirable outcomes. However, the benefits of streamlining must be set against the prospective benefits of a system where the removal of unions' legal monopoly, and the demise of occupational awards with blanket coverage, removed the basic justification for a tightly structured state system. If the state had any cost advantage in the supply of conciliation, mediation and arbitration services, there would be no reason why it might not offer these services on a competitively neutral basis. However, there is no apparent reason, even under the present system, why it should have a monopoly in this market.

The 1987 legislation eliminated constraints on matters on which unions and employers were permitted to negotiate. This represented an important advance, but one that was prevented from reaching its natural conclusion by the retention of a highly regulated, state-run conciliation and arbitation process. It would seem reasonable for employees (or their unions) and employers to be free to negotiate not only wages and conditions but also procedures for the handling of grievances and for the termination and renewal of contracts. This would make provision for the use of mediators or for recourse to arbitration a matter for negotiation, which might or might not feature explicitly in employment contracts. Where it did not, there would be recourse to common law; for example, breaches of contract could lead to a right to sue. Where it did, and there was some conflict with the common law, the contract would take precedence. It would therefore be possible, for example, to set out in a contract conditions under which strike action would (or would not) be allowed. If, as suggested, mediation and conciliation are relatively more efficient as means of resolving differences than litigation, it would be expected that in a less regulated system most contracts would set out, at least, basic conditions for their use.

The Protection of Workers

The stated intention of establishing labour market regulation was to provide a system to protect the interests of workers, in the belief that without protective legislation workers could be exploited by their employers. The social conditions under which protective legislation was first introduced were considerably different from those of the 1980s. The dissemination of information about employers and employment conditions available today considerably exceeds that of the 1890s, as does the geographical mobility of workers. Also, the attitudes to workers' rights that the original legislation sought to enshrine are now widely accepted (the legislation itself reflects the fact that these attitudes had become current). Deregulation would not reverse these trends. Further, general laws on human rights and discrimination have also now been enacted.

More fundamentally, the perception, implicit in the legislation, that the employment relationship is inherently uneven and exploitative is inaccurate. The potential for exploitation is seen to rest primarily in employers' presumed monopsony power,[14] which will be greatest where workers' skills are highly specific and where individuals are geographically immobile. This applied a century ago (for example, in one-factory towns, where workers spent their lives within a few kilometres of their place of birth), but is uncommon today. In the contemporary economy, monopsony, unless protected by government legislation, is unlikely to persist beyond the short term. If a monopsonist's position as an employer is subject to potential competition (that is, another employer can enter the market and bid away his or her employees), the existence of monopsony does not imply that workers are being exploited.

W. H. Hutt points out that the wages and conditions that a worker will accept are determined by his or her access to other employment opportunities.[13] Different workers have different ranges of alternatives, and can therefore command different wages and conditions. It is inaccurate, he suggests, to depict the wages of workers with relatively limited alternatives as more exploitative than those of workers with more or better remunerated alternatives. This is not to say that there are not groups of workers whose relative lack of alternatives makes them vulnerable. However, the creation of monopolistic unions is not a particularly effective means of protecting these workers and, in some situations, the existence of such unions may indeed work against the interests of the most vulnerable by enshrining both restrictions on access to employment and restrictive terms of employment.

Workers and employers enter contracts voluntarily, and in a lightly regulated market would be free to negotiate terms that were mutually beneficial. This is the primary mechanism by which workers are protected from "exploitation" in a labour market characterised by the extent of job turnover and worker mobility that now prevails in New Zealand. The use of unions to negotiate contracts on behalf of workers sacrifices the interests of workers whose skills and preferences differ from the average. The combination of compulsory unionism and national, craft-based unions, rather than protecting the most vulnerable workers (those with low skills, and those on the margins of the workforce) clearly works against their interests. This is illustrated by the concentration of the unemployed among low skilled groups, Maori and provincial workers.

A second form of protection arises from the ability of both employers and employees to look elsewhere for contractual partners. There is increasing evidence that a relatively freely operating market will systematically penalise "bad" or "discriminatory" employers.[14] These employers will find it more difficult and costly to attract labour, and will thus be less competitive in output markets. The range of options available to workers depends on the overall health of the economy, but even in a slowly growing economy workers are not without options. The resources that employers and employees commit to employment contracts mean that both parties have strong incentives to make contracts work. Where the relationship between an employer and an employee does break down, there are, again, protections available. After non-legal remedies are exhausted, there may be recourse to the courts, under the auspices of the common law of contract. These protections will be available without the establishment of a special body of industrial relations law. In so far as the "protections" specifically provided by the 1987 Labour Relations Act (through the conciliation procedures) are relatively costly and cumbersome, they will be a poor alternative to the solutions available in a less regulated market.[17]

A related question is whether there should be government constraints on the content of contracts, beyond the prohibition of criminal practices (such as fraud and coercion) and the statement and enforcement of basic human rights. This question would become more pertinent were the blanket coverage of awards specifying minimum wages and conditions removed.

There is evidence that the predominant effect of minimum wage laws is to reduce access to employment for marginal workers such as the young, the unskilled and racial minorities, effectively redistributing income away from those unable to find work in favour of those who are employed. Minima on working hours, regulation of work practices (for example, specifying limits on hourly output, or acceptable tools) and occupational licensing have been found to have similar (if more subtle) redistributional effects.[18] Even maternity leave requirements and implementation of comparable worth (or equal pay for work of equal value) schemes reduce the access of marginal female workers to employment. The impact of occupational health and safety regulations is less clear (although some evidence from the United States suggests their costs may far exceed measurable benefits).[19] In New Zealand, analysis of their effects is complicated by a state-run accident compensation scheme funded mainly by levies on employers.

Labour contracts should obviously conform to standards that are socially acceptable, but it is not clear that government regulation of contractual terms is the best way of ensuring this. Such terms are more likely to be met in a relatively free labour market, operating at high levels of employment, than in one where mobility is artifically limited by distorted price signals, and where contractual terms are not readily adapted to particular circumstances. The problems that are felt to create a need for standards are rooted far more deeply than in the contractual process. For example, the uneven distribution of women amongst occupations, and the under-representation of women in management positions, which have been presented as a justification for comparable worth legislation, are arguably more a problem of education, access to training and rigid promotion systems than of unacceptable contractual terms.

4. Conclusions: Labour Reform and the Wider Restructuring Process

New Zealand's labour relations system has more general implications for the efficiency and equity of the workings of the economy as a whole, and for the effectiveness of the stabilisation and liberalisation process in particular. Rigidities in the labour market have reduced the capacity of firms and entrepreneurs to adjust to reduced assistance and heightened competition, whether by reducing or increasing their activities, or by creating new firms. In its 1987 post-election briefing to the Minister of Finance, the Reserve Bank commented that:

> The relatively slow progress on labour market . . . reform is in contrast to the pace of reform for the export sector. Yet it is this latter sector that is most affected by inadequate reforms in other markets. The export sector's loss of income from the removal of subsidies cannot generally be regained by increasing export prices, which are determined in world markets. Unless exporters are able to offset this income loss by a reduction in input costs, profitability and hence investment and employment in the sector will decline.[10]

The high labour costs blamed, in some cases, for incapacity to meet competition are not necessarily a signal that liberalisation of the labour market would lead to lower wages. For example, studies by Blandy and Baker[11] show that firms could expect to bring about cost savings through the increased productivity made possible by a freer market; any lowering of wages would cause them to lose employees to competitors.

At least initially, the negative growth and employment effects of the Government's policy of monetary restraint were offset by increases in private sector efficiency, as artificial barriers to competition were lifted. However, the inflexibility of the labour market imposed a major constraint on improved competitiveness and, in combination with a failure to control government spending, carried a risk of large increases in unemployment. Firms unable to compete and constrained in their ability to negotiate productivity-raising agreements with their workers have in many cases resorted to redundancies. This disemployment is likely to have been reinforced by a growing preference for capital-intensive production techniques, encouraged by the reduction of regulatory restrictions in finance markets. For the time being, capital-labour substitution is to some extent being held back by high real interest rates – at least in part a result of the perceived riskiness in investing in New Zealand given its tendency to increased government spending, high debt and the persistent uncertainty of the outcomes of wage bargaining in what the Minister of Finance, David Caygill, has called the "rickety" New Zealand labour market.

A reduction in labout market regulation would have important implications for the overall restructuring process. For firms starting up or expanding, it would increase their capacity to offer packages that attract workers and provide them with incentives to increase productivity. For firms scaling down their activities as a result of restructuring, less regulation would facilitate the use of reduced hours or wages as a means of easing the transition of workers to other employment. Firms that would be forced to shut down, if redundancies were the only means of reducing labour costs, might be able to continue in production. This is likely to be of particular importance in the regions (where the cost of living is typically less than in the cities), thereby greatly reducing the negative impact of increased exposure to competition on regional employment. The general effect would be both to reduce the unemployment losses associated with freeing up the economy and to hasten the process of adjustment towards more productive activities.

The labour market is a highly complex one, and attitudes towards it are coloured by psychological and emotional beliefs. The sanctity of rights and the quest for fairness achieve an emphasis in labour contracts which is unmatched in other economic relationships. Rhetoric flourishes, and fears of loss of control and alienation readily nurture an adversarial view of the relationship between employer and employee, with each side seen by the other as disproportionately powerful and at least potentially exploitative.[22]

The complexity of the market is not in itself a justification for complexity of regulation. A complex society requires less, not more, centralised control, as centralised mechanisms become increasingly incapable of acquiring and processing dispersed information, and of monitoring and controlling economic relationships. This is particularly true in labour markets, where the amount and diversity of information that must be processed for employment relations to operate smoothly means that efficient regulation is likely to be extremely difficult. Comprehensive and intricate regulation, however well-intentioned, often exploits individuals whose abilities or preferences deviate from the norm. It curtails the rights it seeks to protect and reduces the welfare of those it intends to benefit. The argument for reform is not, then, a "narrowly economic" one,[23] nor one that is unmindful of the vulnerability of some workers. It is based on the recognition that only by radical change can the interests of such workers be protected in the short term, and the overall welfare of society be enhanced in the longer term.

The labour market reforms implemented since 1984 fall significantly short of the ideal. Some, such as the raising of the minimum size of unions to 1,000 and the reintroduction of compulsory unionism, have been retrogressive. On the other hand, the current review of occupational licensing is likely to increase access to a number of professions, and the state sector reforms should have a positive effect on overall efficiency and on job creation in the longer term.

While the achievement of some change in bargaining structures has been held up as evidence that the new Labour Relations Act is working, progress has been slow and limited, and many employers and some trade union officials acknowledge that further reform is needed. The increasing rate of unemployment, the absence of aggregate productivity gains and the weak competitive position of the economy all reflect the lag between the rate of change in the labour market and the adjustments being imposed by other economic policies (a point made in criticisms of the sequencing of reform in New Zealand in *The Economist*[24] and elsewhere).

In its 1987 post-election briefing, the Treasury commented that:

> Adjustment to low inflation and assistance reform does impose short-term costs on the economy. Many of the costs can be seen in the form of higher unemployment. While some of these costs are unavoidable in the sense that people's expectations are slow to adjust to a new economic environment, the regulatory framework of the labour market can have a very significant influence over the ease with which adjustment can occur. Unless the regulatory framework is flexible and permissive enough to allow adaptation to changing conditions, the consequences will be felt in continuing high levels of unemployment, lost opportunities for young people to gain skills, continued slow growth in productivity, and poor economic performance.[25]

The characteristic slowness of the labour market to adjust makes the case for further reform all the more urgent.

Notes

1. Organisation for Economic Cooperation and Development. *Labour Market Flexibility*. Paris, 1986, p. 8.
2. This was by means of a voluntary unionism statute rather than by withdrawing the issue of compulsory/voluntary unionism from the reach of the legislation.
3. They are also, of course, affected more generally by government activity in a wide range of areas such as accident insurance, unemployment benefit and tax policy, immigration policy and education policy.
4. For example, the minimum wage was raised in 1987 to $210 per week, which amounted to approximately half the average wage.
5. In 1984, New Zealand was recorded as the third most strike-prone of the OECD countries, having been the least strike-prone in 1971.
6. Quoted in: Blandy, R. & Baker, M. *Industry Assistance Reform and the Labour Market: the New Zealand Experience*. Adelaide, National Institute of Labour Studies, 1987, p. 20.
7. *Industrial Relations: a Framework for Review*. Wellington, Government Printer, 1985.
8. Although house/occupation unions do exist in the state sector, a high proportion of public servants are accounted for by occupation-based unions or the more general Public Service Association.
9. This intention has been subject to a variety of interpretations. For example, one public servant closely involved with drafting the new legislation has been quoted in the press as attributing the need for convergence between the sectors

to the increasingly adversarial cast of industrial relations in the public sector, and citing the greater constraints on the Government's capacity to behave in an exploitative fashion as the chief remaining difference between the sectors. This interpretation seems highly tendentious.

10. Heldman, D. C., Bennet, J. T. & Johnson, M. H. *Deregulating Labor Relations.* Dallas, The Fisher Institute, 1981, p. 56.
11. See: Heylen Research Centre. *Public Opinion Survey of Industrial Relations Issues.* Wellington, 1987.
12. This will depend in part on the recognition of a mutuality, rather than conflict, of interest among parties. A labour contract is not fundamentally different from a contract in any other market, in that it is entered in the first place only because both parties stand to benefit. This recognition is more likely in local than in centralised negotiations.
13. It may be noted that lower wages or reduced hours will not necessarily lead to a reduction in living standards in areas outside the main centres, where the cost of living (particularly through housing and transport costs) is lower.
14. Monopsony arises where there is only one employer in the relevant market.
15. Hutt, W. H. *The Strike Threat System.* New Rochelle, Arlington House, 1973.
16. See, for example: Block, W. E. & Walker, M. A. (eds.) *Discrimination, Affirmative Action and Equal Opportunity.* Vancouver, Fraser Institute, 1982.
17. In this regard, the extension in the 1987 Act of the right to use (less cumbersome) personal grievance procedures for non-union members may be seen as a positive move.
18. Some of the relevant literature is surveyed in Heldman, D.C., et. al., op. cit., and in Reynolds, M. O., *Making America Poorer: the Cost of Labour Law,* Washington DC, Cato Institute, 1987.
19. For a broad review of these issues, see: *Regulating for Occupational Health and Safety.* Wellington, New Zealand Business Roundtable, 1988.
20. Reserve Bank of New Zealand. *Post Election Briefing Paper to the Minister of Finance.* Wellington, Government Printer, 1987, p. 7.
21. Blandy, R. & Baker, M. op. cit.
22. An alternative view, by a union negotiator, is that New Zealand has "weak unions and pathetic employers", both groups being so feeble that they "fell into each others arms". (Quoted in Douglas, R. & Callan, L. *Toward Prosperity.* Auckland, David Bateman, 1987, p. 94.)
23. That as much needs to be made explicit reflects the widespread belief in New Zealand that economic efficiency can only be achieved at the expense of equity, and that market forces are not so much impersonal as actively malevolent. Attention is often drawn, for example, to the high unemployment "cost" of the reform programme in the United Kingdom, without any corresponding comment on the considerable historical rigidity of the British labour market.
24. New Zealand's Economy: Learning to Fly. *The Economist,* 21 November 1987, pp. 25-28.
25. The Treasury, *Government Management.* (Brief to the Incoming Government 1987) Vol I. "The Treasury". Wellington, Government Printer, 1987, p. 270.

Chapter 10

THE POLITICS OF ROGERNOMICS

Simon Walker

ON 14 DECEMBER 1988 ROGER DOUGLAS informed his fellow MPs that he could no longer remain finance minister if David Lange were to be re-elected leader of the Labour Party at the routine mid-term caucus ballot two months later. It was just three days short of a year since the "December 17th package" proclaimed Douglas's boldest policy initiative: a flat tax rate accompanied by a "guaranteed minimum family income" which would target state benefits squarely to (relatively) low-income families. The plan (which was later unilaterally dropped by the Prime Minister) heralded a year of public tension between David Lange and the architect of his Government's economic strategy.

Lange summoned reporters to announce he was treating Douglas's statement as a resignation, and that the Minister of Health (and Associate Finance Minister) David Caygill would take over his portfolio. A week later Douglas, never a personally ambitious politician, challenged Lange in a rapidly rescheduled leadership ballot. Lange won easily, but almost a third of his parliamentary colleagues backed the challenger, leading pundits to suggest that a further leadership bid might follow - perhaps from another challenger. By March 1989 Douglas's public and media appearances had turned him into the Government's most incisive critic.

David Lange became increasingly aggressive towards his former finance Minister and his supporters. The Prime Minister would not "get on a bus" with members of the Business Roundtable. Treasury, which had provided the philosophical firepower behind Rogernomics ". . . would have been against the abolition of slavery".

Should one have been surprised? Perhaps not. The Lange administration had attracted international attention because of its apparent pragmatism. Its image was certainly unusual. But many of its initiatives sprang not from philosophy, but because the victory of a party without the previous Government's electoral baggage permitted long overdue change. Any administration elected in 1984 would have faced the need to urgently remedy inefficiencies which had been tolerated for two decades. The country had relied on tariffs and import quotas, government subsidies and massive borrowing to sustain living standards. While most OECD countries had undergone a process of economic adjustment in the 1970s, New Zealand under Sir Robert Muldoon had postponed structural change. Particular interest groups – farmers, protected manufacturers, subsidised exporters – had prospered through subsidies and high import duties. Their support in turn had been crucial to the Muldoon administration. Many National politicians recognised the economic imperatives but only a successor government was able to make real changes.

The political paradoxes were *very* apparent. In four years, an administration affiliated to the Socialist International and linked to the British Labour Party had deregulated extensively, run ultra-tight monetary policies and made clear its willingness to privatise all commercial state activity. It was a record which might have done Mrs Thatcher proud. Yet running through that era were internal tensions which had been masked but never eliminated.

Ideas, as John Stuart Mill wrote, do not usually have consequences unless events conspire with them. That happened in New Zealand between 1984 and 1988: it was luck, and the zeal of an individual, rather than adroit political management by a committed cabinet which set the country on the path to economic reform. Roger Douglas, a politician whose ideas had changed significantly over his fifteen years in politics, became the right man in the right place at the right time.

The very notion of government intervention in the economy had been discredited by the extent of past reliance on legislative constraints. When an approach has been absolutely bankrupted, when it has been tried repeatedly and failed repeatedly, there can develop a momentum in public opinion which allows for the opposite to occur for a long time. That happened in New Zealand.

The Labour Party behind the Lange Government remained a broadly socialist organisation. Its conferences endorsed a panoply of interventions to right perceived social and economic wrongs. Its officials, and certainly its constituency activists, could fit in the NZLP's British counterpart. Ironically the Labour Party organisation rather than the National Party Opposition provided the most virulent resistance to Roger Douglas's reforms.

Like many organisations on the left, New Zealand's Labour Party has traditionally been split and divided – characteristics which have countered any impression of competence which individual ministers have fostered. Douglas had pledged to maintain a push for lower taxes and less government through to the 1990 general election. His successor appears to be smoothing the way for tax increases and the maintenance of present levels of public expenditure. As divisions rend apart the Labour Government, an ideology-free (some would add largely idea-free) National Opposition seems likely to win office on the basis which decided the 1984 result: dissatisfaction with the incumbents.

But there are fundamental questions about David Lange's administration which must be answered before all prospect of re-election is ceded. Will the Labour Party hold together behind the present government, and on what basis? What has been the extent of public support for change? Which are the interest groups within the community both parties will need to cultivate for the 1990 election? To consider these issues, one needs to revisit the political events of the past five years.

The First Election

The Lange Government was elected almost by accident. It did not publish its manifesto until after the election. The electorate knew what is was voting *against* – it had little idea what it might be voting for.

In June 1984 the then Prime Minister Sir Robert Muldoon had sprung a snap election on his supporters and his opponents alike. New Zealanders are unused to sudden elections. The excuse for the move – the unwillingness of a maverick National MP to vote for the Government on nuclear issues – was transparently spurious. Sir Robert's decision, and the manner of its making, focused the election on his style of leadership. The question was simple: were voters for "our lot or the other lot?"

Political party organisations were unprepared for an early campaign; for National, this was a serious handicap. The Government Party had been lamentably unsuccessful at fundraising. Its organisation was ill-prepared, and its own research showed it was in trouble with floating voters. For Labour, the snap election was a boon. The Party is traditionaly racked by internal controversy as an election approaches, and the fine print of economic policy could be guaranteed to bring the party conflict into open. But, in 1984, the Labour Party had no time to weave a programme out of its diverse strands of opinion. Rather than postulating alternatives to Muldoon's policies, it ran a negative campaign which attacked National but gave few clues about its preferred direction. The leader, David Lange, was presented as a warm and caring prospective prime minister whose "chairman of the board" style contrasted with Muldoon's domineering leadership. The campaign slogan promised that Lange would "bring New Zealand together".

Labour was aided by the only seriously ideological participant in the campaign. The New Zealand Party had been founded by high-profile property investor Robert Jones because of his opposition to Muldoon's interventionist policies. Most of its members were natural National supporters who had become disenchanted with wage and price controls and an effective capital gains tax introduced by their "free market" party. Jones proclaimed the merits of financial deregulation, a floating exchange rate, a switch to indirect taxation, and low (preferably flat) tax rates. The urgent priority, he said, was to get rid of Muldoon, even if that meant a Labour administration. Within a year he delighted in claiming that the new Government, lacking its own manifesto, had "borrowed" his Party's.

If Labour could claim any mandate on economic issues, it came from the New Zealand Party. The new Minister of Finance, Roger Douglas, had proof that his free market inclinations were shared by a signifant proportion of the electorate.

It had been widely speculated that a Labour administration would devalue the dollar, and funds had flown from the country throughout the election campaign. By election day, New Zealand had three days' worth of foreign exchange reserves. On department advice, the incoming Government ordered an immediate devalutation, but a constitutional quirk meant that until the new parliament was sworn in, Sir Robert Muldoon retained technical power. He in turn, refused to act until brought to heel by his cabinet colleagues. On the instructions of the Prime Minister-elect, Muldoon devalued the dollar by 20 percent.

It was a dramatic beginning for the new administration. Douglas's coolness under pressure won general respect and increased his mana within the Labour Party. He had an opportunity to carry an uncertain public with him as he proposed real changes.

The Revolution Begins

The three-year juggernaut of "Rogernomics" did not begin with a bang. Rather, it was launched by a public relations exercise. "The Economic Summit" brought together politicians, trade unionists, business leaders, civil servants and representatives of voluntary sector organisations. All ninety three delegates stood in turn to deliver seven-minute televised homilies on New Zealand's woes.

For all the platitudes, the Summit was an extraordinary exercise in goodwill. The post-election struggle for economic power, and Muldoon's initial refusal to let go of the reins, had dramatised New Zealand's problems. These had already been reflected in Treasury's briefing to the incoming Government, *Economic Management*.[1] The country was massively in debt. The fiscal deficit was routinely 8 percent of GDP and, in addition, the Muldoon Government had borrowed for the energy-oriented "Think Big" projects which now looked like a series of expensive failures. Inflation and interest rates had been artificially suppressed by rigid controls. Treasury's analysis was scathing, its remedies were clear: the free market deregulatory measures it had advocated for years, and which Sir Robert Muldoon had consistently rejected.

An early cabinet discussion set the scene for the Government's approach to economic management. Central to their thinking was the fact that the previous two Labour Governments had been defeated after a single three-year term; the probability that New Zealand Party voters would return to their National roots made it likely that this administration would share their fate. The new ministers concluded that timid policies and an attempt simply to improve economic management by tinkering with current practices would ensure defeat in 1987. Even if the Government moved boldly, victory in 1987 was against the odds: but innovative policies and a complete change of direction were their best hope. Their approach needed to be radical, but they might well have difficulties explaining it to the electorate and, in particular, the Labour Party.

Roger Douglas was personally settled in his economic philosophy, which he had summarised in his book *There's Got To Be A Better Way*".[2] On that occasion, he had been thrown off the Opposition's front benches for advocating devaluation, a floating exchange rate, lower (and flatter) tax scales and the elimination of most subsidies. As Minister of Finance he was the key to the new approach.

Two of the new Cabinet's strongest personalities, David Caygill and Richard Prebble, were put alongside him as associate finance ministers. In previous administrations, "associate" ministers had been either ciphers appointed to assist senior colleagues, or politicians from different factions appointed to moderate them.

With minor qualifications, these finance ministers saw eye to eye on the economy. Together, their influence was so great that after the 1987 election, Prime Minister Lange conceded that he felt compelled to break up the "troika" before it became unstoppable. It was not the only time the PM was to worry aloud about the running of the economic policy.

The Philosophical Shift

Treasury's *Economic Management* had compared the thrust of government policy to a supertanker. It moved slowly, but gathered such momentum that changes of course took months to take effect. Douglas determined to launch new supertankers of his own.

In contrast with previous governments, for whom "fine-tuning" had become an art-form, Douglas promised "clear consistent signals". The new administration would no be "picking winners" as every New Zealand government for fifty-years had attempted to. The "Think Big" energy projects were only the latest in a pattern of government guarantees, subsidies and incentive systems designed to foster particular industries at the expense of other sectors of the economy, each of which sought compensation in turn.

Labour's first budget did away with subsidies and the quirks of tax concessions and special depreciation regimes. It also promised fundamental change to the tax system. Income tax rates of up to 66 percent would be reduced sharply. In October 1985, a uniform value-added tax (the Goods and Services Tax, or GST) would replace all existing sales taxes.

It was the introduction of GST that caused early rumblings from the Government's internal critics. They argued that indirect taxation was regressive, and that high income earners would benefit disproportionately from income tax cuts. In fact, the switch to indirect taxation had been long advocated, most recently by a committee appointed by Sir Robert Muldoon. (Instead, the Muldoon Government maintained differential sales taxes at levels of up to 50 percent on items considered "luxuries", often in addition to other forms of duty. As a result, televisions, video-recorders and cameras in New Zealand were among the highest priced in the world.) After the introduction of GST, public acceptance of the shift was widespread, and the Government reinforced support through extensive advertising.

In March 1985, the exchange rate was floated. A "clean" dollar float proved that Roger Douglas would not be compromising with his critics. Like the previously announced financial deregulation, it was resisted by the left of the Labour Party. Muldoon's regulatory excesses created a perception that Douglas was cleansing the Augean stables. Many left-wing activists were also busy congratulating each other on the Government's nuclear ships ban: the diversion of internal opposition towards foreign policy would be a running theme of the Lange Government.

The Government was moving on other, less visible, fronts. Its tariff cuts were radical by New Zealand standards. Instead of vaguely arguing that they were for the good of the economy as a whole, David Caygill made clear that the reductions were a trade-off between farmers and manufacturers. There was broad public acceptance that every section within the economy had been sheltered for too long. The speed and spread of change became the issue.

Neither farmers nor manufacturers form part of Labour's core support, and anti-protectionist measures stirred little political difficulty. That was not true of reform of the state section. The New Zealand Public Service has long been the butt of jokes, and with some reason. Departments like the Post Office and the Forestry Service had been used by succesive governments to limit unemployment. There were parts of New Zealand where the Forest Service was the only possible employer: forests were planted in places where they could never be milled, including the sides of mountains. Unprofitable post offices were maintained "for social reasons", almost regardless of cost. Organisations like State Coal and New Zealand Railways maintained staffing levels at two or three times actual requirements. Even potentially profitable enterprises lost huge sums of money.

State sector reform would change that. Trading departments would be turned into corporations required to run at a profit, pay taxes and provide a satisfactory return on capital. Non-trading departments were made to introduce user-pays charges wherever possible. Both were to cut costs significantly. There were many redundancies and a significant reduction of services. Departmental budgets were whittled back in all but the sensitive and expensive health, education and welfare portfolios.

The measures worked. As a state-owned enterprise, the Forestry Corporation transformed an annual loss of $70 million into a profit of $30 million; State Coal broke even for the first time in twenty years. But the job losses caused fury amongst the Government's traditional base. The moves added to dissatisfaction in provincial areas, where the elimination of subsidies had already battered the rural economy. Still, the Government soldiered on. Its own supporters were bought off, partly by foreign policy initiatives, and increasingly by the prospect of social policy reform as the economy was set to rights.

But there were issues of great political sensitivity where even a reformist administration was unprepared to act.

The Departures From Form

The administration departed from free market remedies in three key aspects of economic management. Each seems likely to return to haunt Labour in the post-Douglas era. The first was a major extension in welfare benefits.

With the tax changes had come an innovation: "family care" allowances payable on a means-tested basis to relatively lower income families, as opposed to the real "poor". For example, a family with three children earning $270 per week would receive a further $68 in family care, pushing them slightly ahead of the average weekly wage of $335.[3] The Government had, at a stroke, significantly increased the proportion of families entitled to state support. This was hardly a new development. Since 1975, when National introduced non-contributory universal pensions at age sixty pegged to 80 percent of the average adult male wage, access to government payouts had increased. (The new Lange Government imposed a modest means test on that pension, earning considerable voter opprobrium.)

The Government's reforms seemed to be accelerating the rate of dependency. Figures for those on the domestic purposes benefits rose 28 percent over three years while the population increased by 7 to 8 percent. The number of children growing up in households sustained by state benefits rose by 10 percent over the same period, while the number of children in the relevant age group actually declined.[4]

By October 1988, if one added the 120,000 adults on domestic purposes, widows', sickness and invalids' benefits, to the 130,000 registered unemployed and the 500,000 on National Superannuation, a total of 750,000 people, nearly 40 percent of the voting age population, were on benefits intended to substitute for fulltime employment.[3]

Part of the increase in welfare dependency was a result of unemployment. But much of it was not. Labour Party sentiment opposed means-testing and zealous targeting. Some ministers argued that the extension of state benefits to higher income levels was the price that had to be paid to retain middle-class support for the welfare state.

A second hostage to fortune was another consequence of internal Labour Party pressure – the overall growth in government spending. Until the early 1970s, government spending as a proportionof GNP had stabilised at around 30 percent. The Third Labour Government and the Muldoon administration had lifted that figure to 40 percent. The trend seemed inexorable.

While some government departments, like the Ministry of Agriculture, were pruned, expenditure on traditional Labour concerns skyrocketed. Real spending on health and education, for example, rose by around 20 percent in three years (and by 50 percent in money terms). After their 1987 re-election ministers acknowledged that this rise in spending had not been accompanied by an improvement in the *quality* of health or education. To the Government's critics this reflected the standard Labour practice of "throwing money" at a problem in the hope that it would go away. The Prime Minister illustrated the tendency in defending his record on education: the Government, he said, was spending $11.60 for every $10 it had spent the year before.

In short, although a "user pays" approach to particular services meant well-publicised cuts in departmental budgets, the administration failed to rein in government spending overall. Total government expenditure rose from $17,263.8 million to $35,480.9 million over the first three years of Rogernomics.[4]

Significant adjustments were made through the process of "corporatisation", which rationalised staff and funding in unsuccessful state bureaucracies. Although these efficiencies were important, they could hardly make major inroads into the 40 percent of national income consumed by central government. Government was being more disciplined in raising capital: no new overseas borrowing was undertaken after the 1984 election. Debt servicing was by then already at unsustainable levels.

Internal arguments over Douglas's tax reforms obscured one undoubted fact. The Government's tax take had soared. Opportunities to evade tax imposts had been reduced. For many companies – and quite a few individuals - taxation had previously been virtually voluntary. Now GST could not easily be evaded, and the elimination of loopholes for individual taxpayers had closed many gaps. Total taxation rose from 30.4 percent of GDP in 1983/84 to 35.8 percent in 1988/89. In 1988/89 dollars, per capita payments were up from $5,714 to $6,389.[7]

Fiscal conservatism still had its place: it was politically necessary to reduce the deficit. There were two reasons. First, at Douglas's coaxing, government backbenchers had come to see it as the key indicator of his stewardship of the economy. Second, heavy internal borrowing was keeping interest rates at electorally dangerous levels.

If the old Labour priorities - health and education - were to be left inviolate, new sources of funds had to be found. The answer was privatisation: not, as in Thatcher's Britain, as a matter of preference, but a necessity - the consequence of years of New Zealanders' living beyond their means.

The third aspect of deregulation which seemed certain to dog the Government was the most glaring gap on its agenda - labour market deregulation. Labour had deregulated financial markets and floated the exchange rate within months of its election. The theory was that an appropriately low exchange rate would encourage farmers and exporters, and assist structural adjustment as long-standing tariff protection was eliminated. But the fact that government spending was not yet under control meant heavy borrowing at high interest rates. That led to the inflow of foreign capital and a soaring dollar.

The corner of the economy which the administration's new broom would not sweep clean was the labour market. One of Labour's first post-election moves had been to reinstitute compulsory unionism, which had been abolished a year earlier. It was the price demanded for trade union electoral support, although the move clearly contradicted the thrust of economic policy.

Labour market deregulation was high on Treasury's priorities. But internal political pressures forced the Government to back down. The rigid national award system, which limited wage bargaining within any particular enterprise, ensured that workers in provincial areas were paid the same "award" wage applicable in the big cities. So the impact of structural change was felt first in the regions. This was compounded by the rationalisation of state corporations which had previously provided non-economic jobs in remote areas. The upshot was that the labour market could not respond to changes in demand for skills. The result was unemployment, and a big gap between unemployment rates in Wellington and Auckland and the remainder of New Zealand.

It has become fashionable to criticise the sequencing of Rogernomics. The labour market should have been reformed first, the argument runs. Next, trade barriers should have been reduced and the deficit eliminated. Only then should the financial markets have been deregulated.

Such a view emphasises economic trade-offs at the expense of political realities. Roger Douglas's approach was to seek "windows of opportunity" for reform. After a decade of tough exchange rate controls and the periodic imposition of wage, price and interest rate freezes, the opportunity and enthusiasm for financial deregulation was clear. The administration would have courted political disaster by tackling its internal critics head-on via the labour market.

Nonetheless, the omission continues to hamper restructuring. The labour market does adjust more slowly than other sectors of the economy, and the drawn-out pain of manufacturers no longer protected from cheap imports owes much to labour market rigidities. Substantial productivity differentials have led major companies (in forestry, for example) to locate new operations in other countries with less industrial uncertainty.

Another consequence has been the concentration of unemployment. The national award system provides no incentive for businesses to set up operations in the regions and makes it difficult to establish special arrangements with employees which will enable a business under threat to survive.

The reason for passing over labour market reform was the residual influence of unions on "their" Labour Party. Big unions have preferred to keep negotiations centralised, partly to maintain organisational muscle, and partly for fear of the damage "contestability" for membership amongst unions might inflict on those which failed to deliver.

Who Supported Change

The Lange administration's style of economic management won it friends in the business community. That support might have been more strenuously tested if the stockmarket crash had come just *before* instead of just *after* the Government's re-election. As it was, Labour's 1987 election campaign was the most lavishly funded in New Zealand's political history.

The enthusiasm of business, and the contrast between opulence amongst entrepreneurs and mounting unemployment, alienated traditional Labour activists. From being attentive to their supporters' preferences, some ministers became almost ostentatious in their enthusiasm for asset sales and their association with businesspeople who the average Labour Party member believed to possess horns and a tail.

The Labour Party's support base declined markedly. Before the 1984 election it had claimed 100,000 members. By 1988, unofficial membership estimates stood at around 10,000 to 15,000. The Party organisation retained some union support because of its known opposition to government economic policy, but the trade union movement itself became the most vocal critic of Rogernomics.

Labour supporters could console themselves with one prospect. Early in its first term, the Government had appointed a Royal Commission on Social Policy. "Social Policy", party stalwarts were told, would be the key to the Government's second term. Having set the economy aright, *their* government would divvy up the proceeds.

The Royal Commission spent almost two years touring the country accumulating submissions, many of them from activist groups and representatives of the disadvantaged. As expected, its report warmed the hearts of old-style redistributionists and supporters of state intervention. But its detailed recommendations were a prudent finance minister's nightmare. A new "carer's allowance" would pay a benefit to people staying at home to "care" for others. Teenagers would be paid to stay on at school. Far from replacing universal benefits with targeted allowances, in line with government sentiment, the Commission recommended a significant increase in the family benefit, paid to *all* children, regardless of parental income.

After the usual tributes to the Commission's wisdom and hard work, it became clear that its report would gather dust on departmental shelves. Once again the expectations of Labour Party activists had been thwarted.

By the end of 1987, it was obvious that a real recession was touching all aspects of the economy. Any new government spending was being screwed down, even if existing programmes could not be curtailed. The Government's internal critics became bitter.

Testing Times

On 17 December, 1987, Roger Douglas, flanked by six cabinet colleagues, announced a fresh wave of reforms. Labour would drop the company tax to 28 percent, raise GST to 12.5 percent and introduce a single flat rate of personal income tax. The figure was never released, but it was widely believed to be 23 percent. The package would be accompanied by a "guaranteed minimum family income" to top up earnings so that all families with one child would receive at least $370 per week, with $32 for each extra child.

Commentators and members of the Labour Party reeled in amazement. Treasury officials had endorsed a flat rate tax, and Douglas was thought to support the idea in principle, but even free-market enthusiasts assumed the proposition was some distance down the track.

Six weeks later, with Roger Douglas overseas, the Prime Minister entered the argument. He had re-examined the figures, taken (non-Treasury) advice and concluded that politically unsustainable inequities required that the proposal be dropped. He believed it would disadvantage self-employed families and childless low-income earners. He was also unhappy with the "bonanza" for wage-earners in his own tax bracket.

"Now it's Langenomics" trumpeted the media in headlines normally reserved for declarations of war. In retrospect, perhaps, that is what it was.

The decision was Lange's own and reflected his determination to wrest the economic reins from the minister whose views dominated government. The timing could hardly have been worse. Roger Douglas, who learned of the package's demise from journalists, was in London discussing flat tax regimes with the Chancellor of the Exchequer. He was about to travel to Davos to pass on a similar message to an economic policymakers' conference. Financial markets were thrown into a tailspin as Douglas flew home urgently amidst rumours that he would resign.

There followed two weeks of very public anguish before an uneasy compromise emerged. There would be tax *cuts*, to a maximum of 33 percent. There would be no flat tax. GST would not be increased. For the first time in three-and-a-half years, the ever-present rifts within the Party had percolated through to the top echelons of government.

Lange's intervention had been clumsy, even if it reflected a majority view that Douglas had "gone too far". Just six months after its re-election, opinion polls showed the Government 16 percent behind the Opposition (itself crippled by uncertainties over economic policy). It was a lead the National party would continue to hold.

Within a week, the row resurfaced. Lange announced the Government would, at an unspecified point, introduce a capital gains tax. Three months later, the Prime Minister appeared to threaten even the agreed tax cuts when he raised the need to rein in a massively miscalculated fiscal deficit. That skirmish was won by Douglas, whose 1988 Budget put the onus on government departments to make sizeable reductions in spending. But a fall in staff numbers seemed more likely than a reduction in health, education and welfare payments.

Then, in August, the Prime Minister promised to slow the pace of economic change, noting that unemployment had reached "unacceptable levels". His finance minister appeared to contradict him. In September 1988, it was only David Caygill's refusal to take over the finance portfolio which stopped David Lange removing Douglas. Six weeks later he sacked Douglas's chief supporter, the Minister of State Enterprises, Richard Prebble. It was a sign that Lange had asserted control.

Privatisation had proved a second source of division. Early in 1988, the Government reneged on an agreement to sell state-owned

Petrocorp to British Gas after strong opposition to its control by a foreign buyer. The July Budget made clear that virtually all state enterprises were for sale, regardless of past pronouncements.

In September 1988, the Government agreed in principle to sell 25 percent of Air New Zealand to the Australian airline, Qantas. A month later Cabinet reversed itself: it now seemed likely the whole airline would be sold, with 35 percent going to British Airways. Politically, the misfortune was not foreign ownership; it was the re-opening of negotiations on a new proposal well after the deadline for bids had closed. Prebble strongly backed the change. Lange seized the opportunity to assert his authority, and the entire airline was subsequently sold to a consortium which included the Australian company.

By the end of 1988, it was apparent that Lange was doubtful about continuing the process of economic rationalisation. He had several times aligned himself with the Labour Party against his own finance ministers. Lange's public image of being dominated by his colleagues had became a source of personal hurt. He needed to demonstrate the forceful political presence behind his vague proclamations of care and concern.

The public tension throughout 1988 had unsurprisingly polarised the staff supporting the two principal protagonists. In December the Prime Minister ordered the dismissal of Bevan Burgess, Douglas's press secretary and confidante. It was a bizarre intervention into a staff matter with which few political leaders would have troubled themselves. The move seemed expressly designed to pique his colleague, who was overseas at the time, and it did so. The Minister of Finance mulled things over and, a week later, announced that he would not serve under a re-elected Lange. He also released documents showing that the Prime Minister had been at best selecive and at worst duplicitous in his public pronouncements on economic policy.

On this occasion Lange did secure David Caygill's agreement to serve as Douglas's successor. After falling dramatically, the New Zealand dollar stabilised as the new minister promised that "Rogernomics" would continue.

Caygill had spent almost four years as Douglas's understudy, but over the next few months doubts grew about the extent to which he would carry out his predecessor's intentions. Certainly he was committed to reducing the government deficit, and by February 1989 the Government appeared likely to need $2 billion in spending cuts or additional revenue in order to meet a targeted figure of 1 percent of Gross Domestic Product. But increasingly it appeared likely that this would be achieved by raising taxes rather than making significant reductions in government spending. Mr Caygill made clear that he would "not exclude" a hike in personal and/or company tax. By

March the Prime Minister was arguing that increases would not be punitive, rather than denying that they would take place.

The Political Dilemma

The Government's internal conflicts raise paradoxes which run beyond the rivalries of individual politicians.

"Rogernomics" has created wealth. It has slashed what a Labour Government might regard as "discretionary" spending: export incentives, farm subsidies and government underwriting of the "Think Big" projects encouraged by the previous administration. But it has had to cope with the consequences of years of fiscal profligacy. New Zealand's external debt is 70 percent of GDP, a figure comparable to Venezuela or Bolivia. Interest on government borrowing absorbs 25 percent of total tax payments.[8]

It has failed to curb big spending departments, while powerful lobby groups have clamoured for increased social expenditure. Government handouts to unimportant political constituencies *have* been axed. The difficult areas - health, education, and social welfare - have not been cut; indeed, they consume more funding with no claimed improvement in standards.

In his December 1987 package Douglas tried, and failed, to persuade his colleagues to apply efficiency tests to areas of social spending. He wanted to take the State out of the business of owning houses, for example. He conceded a role in helping low-income earners bridge the "affordability gap" for renting and home mortgages, but providing the full amount of low interest loans and owing large tracts of rental accommodation was actually increasing housing costs for the poor. His colleagues declined.

Cabinet also refused to extend "user-pays" principles to the health service. The state would have remained the primary funder of health care, but patients earning above average wages would have contributed to the cost of treatment on a means-tested basis. The proposal cut across too many Labour Party shibboleths and it was shelved.

The Lange Government has shown innovation and determination in every aspect of economic management *except* the control of public spending. The excesses of the welfare state - a bloated bureaucracy, badly targeted benefits, incentives which discourage productive investment and employment - have been bolstered by the fruits of deregulation and increased tax revenues.

The membership base of the Labour Party, with a high proportion of teachers, public servants and trade union officials, leaves it particularly susceptible to interest group pressure. Few cabinet ministers seriously supported their Government's reimposition of compulsory trade union membership, for example, but most believed it was "a price which had to be paid" to a key constituency.

Ironically, by maintaining pressure for increased social spending, left-wing critics of Rogernomics have forced their administration into what they regard as the ultimate heresy - privatisation. For an administration which refused to borrow overseas but is committed to a tight monetary policy, the process of funding an ever expanding welfare state leaves little choice. Even the sale of *all* government corporations will not reduce New Zealand's debt from 60 percent of GDP to the 10 percent level it stood at in 1974. That was the year before spending on big ticket items – health, education, housing and, above all, social welfare – really took off.

The achievements of the Fourth Labour administration are considerable, but its shortcomings are also plain. It was always hard to see how the ideological contradictions Roger Douglas's demise has brought into the open could be resolved within a single political organisation. When Douglas started to stir the traditional icons of universal benefits, a free health service and a heavily graduated tax scale, his party critics intensified their opposition. Like Hugh Gaitskell, the British Labour Party leader who challenged the totems of an earlier era, New Zealand's finance minister found that, in words which Gaitskell liked to quote:

> Idols . . even when they are so quiescent as to seem almost lifeless, have a capacity for becoming suddenly and violently inflamed . . . no politician can hope to prosper unless he has a weather sense that warns him in good time what to expect . . . (for) an idol whose worshippers have taken alarm may threaten him with disaster.[9]

Where to Now?

Rogernomics has been a bold experiment. Unlike the Thatcher or Reagan administrations, the Lange Government was elected without any clear mandate. Roger Douglas stepped into a vacuum. He proceeded on the basis of minimal support from within the Labour Party, and little understanding among the general public of the scale or intent of planned reform.

It was not a government of consensus. Rather, it seized opportunities to change practices which had become entrenched in the New Zealand economy: enthusiasm for government intervention, widespread cross-subsidisation and a highly judgemental approach to individual economic choice. And as a government it needed to go further than the historic reins of Labour Party traditions allowed. After the Cabinet fragmented at the end of 1988, there seemed little prospect that the Labour Party would hold together around a policy of economic rationalism.

In statistical terms, 1985-88 has been a bleak period for New Zealand. Real economic growth has totalled 4.1 percent to Australia's

16 percent and an OECD average of 12.7 percent. Employment growth has been 0.4 percent, against Australia's 12.7 percent and the OECD's 5.7 percent.[10] Yet four years of Rogernomics brought about adjustments other countries made over a period of decades. It is the misfortune of New Zealand governments that, unlike their British counterparts, they have to face electoral judgment every three years.

New Zealand politics is uncertain enough to ward analysts off predictions too far in advance of an election. The National Party has its own sectional feuds. By 1990, the traditional bases of support for both major parties will have been considerably changed. The 1987 election saw gains for Labour in the most affluent urban electorates; working class constituencies showed sharply reduced majorities. In mid-1988, Labour Party polling showed that many cabinet ministers would lose their seats in an election.

Indeed, it may end up being racial rather than economic issues that determine the electorate's judgement on the Fourth Labour Government. The Lange administration recognised the statistical inequities between Maori and non-Maori, and the undoubted historical injustices which have helped bring them about. But by giving the judicially-based Waitangi Tribunal the power to examine claims dating back to 1840, the Government has raised substantial Maori expectations – and risked generating a white backlash.

Certainly, the 1990 election seems likely to be decided by "middle New Zealand": the less affluent, socially insecure, largely European suburban community which endorsed Norman Kirk in 1972 and was so successfully captured by Sir Robert Muldoon from 1975 until his electoral demise in 1984. It is a community which feels threatened, by unemployment and economic restructuring, by crime, by immigration, by the clamour for Maori self-determination and the righting of historical wrongs. The politicians who reassure those New Zealanders are those likely to win the 1990 election – and to pick up the fruits of Rogernomics, and the challenges which it failed to address.

Notes

1. The Treasury. *Economic Management*. Wellington, Government Printer, July 1987.
2. Douglas, R. O. *There's Got to be a Better Way*. Wellington, Fourth Estate, 1980.
3. *Statement on Taxation and Benefit Reform*. House of Representatives, 20 August 1987; *New Zealand Yearbook 1987-88*, Wellington, Department of Statistics, p. 344.
4. Campbell, Gordon. New dawn or darkness? *New Zealand Listener*, October 29, 1988, p. 18.
5. Ibid.

6. Comparisons of total gross government spending for years ending 31 March 1984 and 31 March 1987. Source: The 1984 and 1987 Budgets.
7. Minister of Finance, written reply, Order Paper, 20 October 1988.
8. Campbell, Gordon, op. cit.
9. Williams, Philip. *Hugh Gaitskell*. Oxford University Press, 1982.
10. Easton, Brian. Economy column. *New Zealand Listener*, 29 October 1988, p. 57.

APPENDIX

Chronology of Major Tax Reform and Fiscal Policy Announcements and Measures, July 1984-July 1988.

Ian Dickson and Bryce Wilkinson

The following chronology outlines the main announcements and events in the areas of fiscal policy and tax reform since the election of the Labour Government on 14 July 1984. The assistance of Roger Beckett of the Tax Policy Division of the Treasury in compiling it is gratefully acknowledged.

15 August 1984 Elimination of Export Incentives

Announcement of programme to eliminate all major export incentives by April 1987.

8 November 1984 Budget

The Minister of Finance, the Hon. R. O. Douglas, presents the Budget for the 1984/85 financial year. Main features:

- In the 1984/85 fiscal year, total net government expenditure forecast to rise by 9.2 percent to $15,556 million, while total revenue forecast to be up by 14.8 percent to $12,795 million, resulting in a deficit of $2,761 million, equivalent to 7 percent of GDP. [Actuality: the 1984/85 deficit outcome - $2,784 milion.]

- A comprehensive goods and services tax (GST), accompanied by reform of existing indirect taxes (including the wholesale sales tax to be retained in a reduced form on a limited range of goods) and changes to the personal income tax and social welfare systems, to be introduced from 1 April 1986. The tax to be administered by the Inland Revenue Department, and the Government to release a White paper early in 1985 containing proposals for the administration of GST and inviting public submissions.

- A fringe benefit tax (FBT) on employer-provided cars, low-interest loans and free, subsidised or discounted goods and services to be implemented from 1 April 1985. Taxable in the hands of the employer, with the tax to be levied at the rate of 45 cents per dollar of fringe benefit paid to employees.

- A surcharge on the taxable "other income" of each national superannuitant in excess of $5,200 per annum at the rate of 25 cents per dollar of this excess with the maximum surcharge equal to the national superannuation payment to be effective from the income year commencing 1 April 1985.

- A "family care" package of $10 per week per child (tax free), to be effective from 4 December 1984. Targeted specifically at low- and middle-income families, and abated at the rate of 25 cents per dollar of household income above $20,470 per annum.

- The maximum value of the principal income earner rebate increased from $312 to $520 per annum as part of the "low income assistance package" (the major component of which was the "family care" programme), and the standard marginal tax rate on personal income increased from 31.5 to 33 percent across a slightly expanded income bracket to assist in the financing of the package. Both measures to take effect from 1 December 1984. [Actuality: in 1984/85 prices, the increases in the principal income earner rebate were estimated to cost $52 million in 1985/86, and the increase in the standard marginal tax rate and bracket to yield $143 million net in 1985/86.]

- Wholesale tax rates on a variety of goods – namely, computer equipment, records, recorded tapes, blank magnetic tapes, cosmetics, caravans and boats – reduced (to either 10 or 20 percent).

- Taxes on beer, wine and spirits increased, in part as a move towards a more uniform approach to the taxation of alcoholic beverages.

- The personal tax exemption for life insurance premiums and superannuation contributions to be abolished from Budget Night for new contracts of life insurance, personal lump sum superannuation and non-subsidised employee lump sum superannuation. In addition, a review of all aspects of the taxation of life insurance, superannuation and related areas announced.

- The income tax rebate (with a maximum value of $1,000 for five years) for interest payments on first home mortgages removed for houses purchased after Budget Night, and the rebate of up to $25 for local body rates terminated with effect from the income year commencing 1 April 1985. [Actuality: total revenue gain, in 1984/85 prices, of $27 million in 1985/86 and $40 million 1986/87.]

- Various subsidies and incentives (affecting fertiliser transport, fertilisers, product inspection by the Ministry of Agriculture and Fisheries, farming and agricultural investment and forestry encouragement) either removed completely or to be phased out over a period of years.

- Interest rates on government-funded rural lending to be progressively increased to market levels.

- Similarly, the price of state-supplied electricity and coal to be progressively increased to levels reflecting the full cost of supply. As a first step, as from 1 April 1985, the average bulk electricity tarrif to be increased by 225 percent, while non-export coal to rise in price by 35 percent.

- Road user charges adjusted to cost-recovery levels, rising by an average of 46 percent from 1 February 1985.

10 November 1984 Motor Vehicle Industry Plan Announced

The Minister of Trade and Industry announces the motor vehicle industry plan, including, from 10 November, cuts in sales tax rates on motor vehicles with an engine capacity exceeding 1350 cc to 33 percent, and that on other vehicles to 30 percent. [Previously, rates of 37.5, 40, 50 and 60 percent had applied.] Tax on motor cycles reduced to a uniform 20 percent from rates of 20, 30, and 40 percent, depending on engine size.

6 December 1984 "Budget '85" Taskforce Announced

The Government announces the establishment of the "Budget '85" Taskforce. Comprising six officials from the Departments of Inland Revenue, Social Welfare and the Treasury, the Taskforce to tour the country in 1985 in order to increase public awareness, and to investigate options for reforms to the social welfare benefit and personal income tax systems. An indication also given of the Government's intention to establish later in 1985 a Royal Commission on Social Welfare to evaluate the broader aspects of the social welfare system.

18 December 1984 Fringe Benefit Tax

Draft legislation to implement the Fringe Benefit Tax introduced into the House of Representatives and referred to the Commerce and Energy Select Committee. [Outcome: 312 submissions received by 1 February 1985. The Select Committee recommends amendments to the original draft legislation on 15 March 1985.]

14 February 1985 Increased Superannuation Exemption

Minister of Finance announces increase in exemption level of taxable "other-income" for national superannuitant surcharge – in the case of single superannuitants, from $5,200 to 6,240 per annum. Married superannuitants to be able to split their other income to combined total of $10,400 per annum for purposes of the surcharge. Both changes to take effect from 1 April 1985.

18 March 1985 "Budget '85" Taskforce Discussion Document

Ministers of Finance and Social Welfare release "Budget '85" Taskforce discussion document on personal income tax and social security benefit systems, and invite public submissions relating to reform of these systems. [Outcome: the Taskforce subsequently participates in public meetings and hears oral submissions in all main centres as part of consultative process.]

26 March 1985 White Paper on GST

White paper on GST, incorporating draft legislation, released by Minister of Finance, who invites public submissions by 17 May 1985. [Outcome: these considered by advisory panel under chairmanship of Dr Don Brash.]

24 April 1985 GST on Land and Accommodation

Inland Revenue Department releases commentary and draft legislation on treatment of land and residential accommodation under GST. Public submissions invited by 17 May [later extended to 31 May.]

4 June 1985 Brash Report on GST

The GST Advisory (Brash) Panel, after receiving 1,459 submissions, presents the first report to Minister of Finance. Report suggests a number of simplifications to the tax as proposed in White Paper. GST treatment of financial services, land and residential accommodation left aside for second report.

5 June 1985 GST Co-ordinating Office

Minister of Finance announces appointment of Jeff Todd to head small public information unit known as the GST Co-ordinating Office, whose responsibility will be to ensure that information needs of the public and affected interest groups are met.

6 June 1985 GST on Financial Services

Minister of Finance releases proposals for treatment of financial services under GST and invites public submissions to Brash panel by 20 June [date later extended to 27 June].

13 June 1985 Budget

Minister of Finance presents Budget for the 1985/86 financial year. Main features:

- A forecast deficit in 1985/86 of $1,286 million, equal to 2.8 percent of GDP; mainly due to very strong revenue growth, forecast to be up by 28.4 percent to $16,096 million in 1985/86 (35.2 percent of GDP). Government expenditure forecast to increase by 13.5 percent to $17,382 million (38 percent of GDP). [Actuality: the 1985/86 deficit outcome – $1,871 million.]

- Expenditure on education, health, housing and defence to be increased.

- Employment and training programmes, designed to target assistance to individuals and groups facing the most severe employment problems, to be redirected.

- From 1 April 1986, exempt levels of taxable "other income" of national superannuitants to be increased from $10,400 per annum for married couples and from $6,240 to $7,200 per annum for single persons.

- Sales tax on cash registers reduced from 40 to 10 percent from Budget Night, to assist businesses preparing for introduction of GST.

- Charges for government services, including those provided by the DSIR, Forest Service, Ministry of Works and Development, and Ministry of Agriculture and Fisheries, introduced.

- The resources rental, currently applying to the deep water fishery and announced for the inshore fishery, extended to other commercial marine fisheries.

- Expenditure priorities across government departments to be more rigorously assessed.

- Charges for government-provided services increased to full cost recovery basis.

- Public sector efficiency to be improved by moving state-trading enterprises to a more commercial and competitive basis.

15 June 1985 GST Delayed

In light of changes to GST agreed on as a result of the first advisory (Brash) panel's report, and the need to allow adequate time for reference of the GST Bill to a Select committee, the Deputy Prime Minister and Minister of Finance announce a delay to the introduction of GST from 1 April 1986 to 1 October 1986.

21 June 1985 First Brash Report

Minister of Finance releases first report of the Brash Panel, excluding discussion of transitional issues (defined as commercially sensitive). Minister accepts many of the Panel's recommendations.

24 July 1985 Second GST Advisory Report

The Brash Panel, after receiving 55 submissions, presents its second report to the Minister of Finance, with recommendations on the application of GST to financial services, residential accommodation and property. [Note: Of the submissions received, 36 dealt primarily with financial services and 10 with real estate issues.]

20 August 1985 Major Taxation and Benefit Reforms

Tax reforms of a far-reaching nature announced by Minister of Finance in the second major financial statement of the year. The announcement includes these features:

- A comprehensive goods and services tax (GST) to be introduced from 1 October 1986 to raise $2.7 billion in a full year. Rate to be at a uniform 10 percent with an estimated one-off CPI impact of no more than 5 percent after allowing for remission of certain existing indirect taxes (namely, sales tax, film hire tax, lottery duty, international departure tax and domestic air travel tax).

- Selective taxes, in addition to GST, to be continued on alcoholic beverages and tobacco products. Racing duty also to be continued, but reduced to take account of GST. Selective taxes, as well as GST, imposed on motor vehicles.

- Customs duty, energy resources levy, motor vehicle fees and charges, road user charges, motor spirits duty and equivalent taxes on CNG and LPG retained.

- Stamp and cheque duties to be reviewed in the 1986 Budget.

- Transitional measures relating to GST on long-term contracts brought in.

- Company tax and Fringe Benefit Tax rates to be increased from 45 to 48 percent for the income year commencing 1 April 1986, and to coincide from 1 October 1986 with the new top marginal personal income tax rate.

- A full imputation system for taxation of distributed company income to be introduced from the 1988/89 financial year.

- Legislation to be brought in which would make dividends paid from capital sources taxable in shareholders' hands; legislation to be effective from 20 August, and to act as an interim measure pending the introduction of a full imputation system.

- From 20 August, taxation of income derived from overseas by New Zealand companies by way of dividends on redeemable preference shares, interest on convertible notes or interest on equivalent securities, where the related payment is deductible to the offshore firm.

- Personal income taxes to be cut by $2.1 billion (a 19.2 percent cut) from 1 October 1986. The top marginal rate, applicable to incomes above $30,000, to fall from 66 percent to 48 percent.

- Income to be substantially redistributed in favour of lower- to middle-income groups, incorporating new welfare benefits. A new package of family assistance to be available to low- and middle-income earners, income-tested beneficiaries and national superannuitants. "Family Support" to replace the existing family care programme and family tax rebate, and to be split equally between the partners in a two-parent household. Where practical, Family Support to be delivered through the personal income tax system, allowing for tax credits if entitlement to assistance exceeds PAYE liability. In addition, a guaranteed minimum family income of $250 net per week (including family benefit) for full-time earners with one dependent child, augmented on this basis by $22 per week for each additional child, to form part of the new family assistance programme. These measures to be effective from 1 October 1986.

- All income-tested benefits not already taxed to become taxable on an end-of-year basis from 1 October 1986. Entitlement to income-tested benefits to be split equally between married couples (including de facto couples), and recipients to be taxed as individuals.

- An estimate that the 1986/87 effect of these measures will be to increase the fiscal deficit by $1 billion, implying about a 4 percent increase in private real disposable incomes.

22 August 1985 Second GST Report Released

Minister of Finance releases the second report of the GST Advisory Panel, as well as reports by the Treasury concerning the application of GST to financial services, residential accommodation and property. The Minister indicates that the Government has decided to proceed with its original proposals in these areas. GST Bill introduced into the House and referred to Finance and Expenditure Select Committe.

27 September 1985 GST Bill Passed

Written submissions to the Select Committee on the GST Bill closed. The Committee has considered 260 written and oral submissions. [Outcome: the second reading of the Bill is completed on 26 November and the Royal Assent given on 3 December 1985.]

12 December 1985 Economic Statement

A set of economic policy measures is outlined in a statement to Parliament by the Minister of Finance. Although the measures primarily concern taxation changes and import tariff reductions in response to difficulties being experienced by the farming sector, the Minister also discusses public sector efficiency, changes to the operations of the state-owned enterprises and a review of industrial relations legislation. The following tax measures announced:

- Abolition of the 10-year clawback rule in section 129 of the Income Tax Act 1976 (under which interest and development expenditure deductions were reassessed up to the amount of any profit on the sale of land within 10 years of acquisition) in respect of sales of agricultural, horticultural, aquacultural and forestry land where such sales become unconditional after 12 December.

- Abolition of the $10,000 loss-offset limitation in section 188A of the Act (under which only the first $10,000 of losses arising from specified activities costs can be offset against other assessable income) for livestock or arable farming from income year commencing 1 April 1986.

- Removal of immediate write-off of development expenditure in the primary sector (agriculture, horticulture, aquaculture and forestry) and of forestry planting and growing expenditure with a five-year phase-out over income years ending 31 March 1988 to 1992, to be replaced, where appropriate, by a depreciation regime. Committed primary sector expenditure subject to binding contracts at 12 December 1985 permitted an additional year of full deductibility. For existing forests (those planted on or before 31 December 1986 on land owned on or before 12 December 1985), the immediate write-off of development and growing expenditure to be retained until the income year ending March 1997.

- Abolition of the existing nil and standard value systems of livestock valuation and taxation from income year commencing 1 April 1986; to be replaced by trading stock scheme or herd scheme with new standard values based respectively on 70 percent and 100 percent of average market values. Farmers required to write up their livestock to the new standard values. To assist adjustment, 50 percent of livestock revaluation income to be written off and the remainder spread, for tax purposes, over up to a 13-year period (income years ending 31 March 1986 to 1998). For farmers who cease farming before 1 April 1987, the existing three-year forward spreading of assessable income to be extended to five years.

- Reduction of tariff rates to zero on goods not made in New Zealand, unless trade policy obligations require otherwise. [Outcome: the cuts affected several hundred tariff categories and took effect from 19 December 1985.]

The Minister indicates that a committee will be established (on much the same lines as that which considered GST) to report to the Government on implementation of the new development expenditure regime and livestock valuation schemes, the objective being to ensure that these changes will be introduced and operated with a minimum of difficulty.

16 December 1985 Committee on Livestock Taxation

A consultative committee of private sector experts under the chairmanship of Dr Don Brash established to consider submissions on a forthcoming consultative document on the taxation of livestock and primary sector capital expenditure, and to report with recommendations to the Ministers of Finance, Agriculture and Forests on the implementation and administration of the proposed tax changes.

10 March 1986 Primary Sector Taxation Details

Minister of Finance releases the consultative document on primary sector taxation which presents details (with some amendments to proposals in the Economic Statement on 12 December 1985) of changes to the taxation of livestock and of primary sector capital expenditure. Submissions to the Consultative (Brash) Committee invited by 4 April 1986.

14 March 1986 Sales Tax Act

Minister of Customs announces the Government's intention to repeal the Sales Tax Act 1974 once GST is in place. Remaining selective indirect taxes (on alcoholic beverages, tobacco products, petroleum and gaseous fuels and motor vehicles) to be collected on an excise basis.

20 March 1986 Display of GST

Minister of Consumer Affairs announces GST taxpayers have option of displaying prices inclusive or exclusive of tax. The Government expresses preference for prices at the retail level to reflect the all-up price.

26 March 1986 Sales Tax Cuts

Ministers of Finance and Customs jointly announce cuts in sales tax to take effect on 1 April 1986. Sales tax rates on goods of 30, 40 and 50 percent reduced to 20 percent. Sales tax levied at specific rates and *ad valorem* rates on tobacco products unchanged. Sales tax on motor vehicles (over 1350 cc engine capacity and under 3.5 tonnes gvw) reduced from 33 to 30 percent.

1 April 1986 "Benefits, Taxes and the 1985 Budget"

Ministers of Finance and Social Welfare release *Benefits, Taxes and the 1985 Budget: a review and summary*, a report prepared by the Department of Social Welfare. Report outlines the process of public participation and analyses submissions received following release on 18 March 1985 of the discussion document on the same topic. In total, 1,374 submissions received, of which 864 from individuals and 510 from groups.

19 May 1986 Government Expenditure Reform

The Government releases *Statement on Government Expenditure Reform*. The trading activities of the Electricity Division, State Coal Mines, Post Office and Civil Aviation to be changed from departmental organisations to corporate structures. The major changes facing these organisations include the need to finance activity by borrowing in ordinary financial markets, the need to pay tax and (usually) a dividend, and the removal of many special privileges previously embedded in legislation and practice. The major benefits expected are an improved structure of incentives to perform designated functions efficiently, and clearer identification of the underlying resource costs of such functions.

31 July 1986 Budget

The 1986 Budget is presented to Parliament by the Minister of Finance. Measures include:

- Confirmation that the introduction of the Goods and Services Tax and cuts in income tax planned for 1 October 1986 will proceed as announced.

- Minor changes to previous announcements about indirect taxes which will remain after the introduction of GST. These are a reduction in the rate of indirect tax applying to motor vehicles from 30 to 25 percent on 1 October 1986, to 20 percent on 1 July 1987 and, finally, to 15 percent on 1 July 1988. Contrary to previous announcements, lottery duty to be retained.

- A reduction in the rate of surcharge on national superannuitants' other income, from 25 to 18 percent from 1 October 1986.

- Measures modelled on Canadian legislation to bring tax treatment of income and expenditure closer to normal accounting treatments, including changes to the definition of interest and assessability of interest, and returns on debt securities to be assessable on a yield to maturity basis. New rule to apply from Budget Night to new issues and acquisitions. Details to be published within a month and a consultative committee to be established.

- Commissioner of Inland Revenue to have the power to deny reduction in respect of payments to non-residents in cases where requests for substantiating information are not complied with.

- Treatment of special (limited liability) partnerships as companies for tax purposes.

- Termination, from Budget Night, of first year depreciation allowance for manufacturing plant and machinery and other accelerated depreciation allowances for farming, fishing and tourism industries.

- Depreciation limit on motor cars to be removed from the 1988 income year.

- Review of ordinary rates of depreciation to be undertaken in due course as part of the business tax review.

- Special tax concessions on petroleum mining industry and investors in mining companies to be withdrawn. The Government to consult with the petroleum mining industry on details of a neutral tax regime to replace existing provisions.

- The Government to consult the bloodstock industry on reducing the rate of depreciation of bloodstock and other changes to the tax treatment of breeding and racing activities.

- Changes in the timing of provisional and terminal tax payment to improve the pattern of tax flows to the public account. Provisional tax to be payable in three instalments on the 7th day of the 4th, 8th and 12th months of the income year from the 1988 income year. Transitional date provided for the 1987 year. Terminal tax rate to be shifted to 7 February from 7 March for most taxpayers.

- Excise duty on tobacco products to be increased by the equivalent of 70 cents for a packet of cigarettes from Budget Night.

- The Government to assume direct responsibility for major project and producer board debt worth $7.2 billion as part of the process to deregulate protected industries, improve efficiency in the economy and restructure "Think Big" projects. The Government to assume the existing 16 cents per litre refinery expression levy on petrol and diesel as an excise tax. This to have no effect on fuel prices. The Liquid Fuels Trust Board levy and Consolidated Account refunds of petrol tax both to be abolished.

- An estimate that the fiscal deficit for 1986/87 will be $2,452 million, around 5 percent of forecast GDP. [Actuality: the 1986/87 deficit - $1,953 million.]

1 October 1986 Introduction of Goods and Services Tax

Main features:

- A flat 10 percent consumption tax on goods and services.

- Major exemptions restricted to existing housing sold by unregistered persons, financial services, sales of secondhand goods and fund-raising activities.

- Reductions in income tax rates.

- Increases in social welfare payments to low-income families.

- Abolition of sales tax in most areas.

29 October 1986 Accrual Tax Proposed

Proposals to close business tax loopholes unveiled in *Consultative Document on Accrual Tax and Treatment of Income and Expenditure*. The Finance Minister says the proposals are aimed at making income taxable as it is earned and at preventing expenditure becoming tax deductible before the period to which it properly applies.

17 December 1986 "Double Dipping"

The Government's intention to legislate against "double dipping" of deductions by dual resident taxpayers announced.

1 April 1987 State-Owned Enterprises Legislation

Legislation to create nine new public corporations structured on commercial lines comes into effect.

18 June 1987 Budget

The Minister of Finance presents the 1987 Budget. Highlights include:

- The first forecast surplus (of $375 million) for 1987/88 in 35 years, in good part achieved by major asset sales and semi-government borrowings giving net repayments of $1,694 million. [Actuality: the outcome was a $467 million surplus which contributed to the first reduction in the public debt in 35 years.]

- A forecast net financial deficit (the best measure of the deficit in the circumstances) of $1,274 million, 2.2 percent of GDP, down from 3.6 percent on the previous year, a drop of $589 million. [Actuality: the outcome was a deficit of $1,147 million.]

Also announced are intentions to:

- Proceed with the introduction of a system of full imputation of dividends in 1988/89.

- Move against use of tax havens by resident taxpayers along the lines of controlled foreign corporations regimes; a consultative document to be released for public submissions in September.

- Pass legislation to eliminate the tax avoidance practice of "double dipping"; legislation to be effective from income years commencing after 17 December 1986.

- Sell equity bonds (equivalent to non-voting shares) in state-owned enterprises, starting, this financial year, with the issue of 25 percent of the total paid-up capital in the Forestry and Government Property Services Corporations. The Government to investigate authorising other SOEs to make similar equity bond issues.

- Sell 25 percent of the Government's shares in Air New Zealand, and to proceed with the issue of shares in the Development Finance Corporation.

- Reduce overseas public debt by $600 million.

Other measures announced include:

- Following the 17 December 1986 Economic Statement, dual resident companies to be prevented from grouping losses for tax purposes with effect from income years commencing after 17 December 1986.

- From 1 April 1987, the level of joint income at which Family Support begins to abate to be increased from $14,000 to $15,000. The benefit to be available in tax returns for the 1988 years.

- A $20 increase in the weekly guaranteed minimum family income.

- From 1 April 1987, the exemption level for the national superannuation surcharge to be $13,000 for a married couple and $7,800 for a single superannuitant.

17 December 1987 Economic Statement

As part of an economic statement, several ministers make statements on intended major economic reforms. In the taxation field, the Minister of Trade and Industry announces changes to tariff policy, and the Minister of Finance announces wide-ranging tax base, tax rate and family assistance measures.

The intended tariff reforms are:

- A reduction of tariffs on motor vehicles and components from 1 January 1989.

- Tariffs on goods not subject to industry plans to be reduced by half in five steps between 1 July 1988 and 1 July 1992.

- Goods subject to specific rates of duty to be coverted to *ad valorem* on the expiry of present industry plan.

- Goods subject to industry plans to become subject to the general tariff reduction programme on expiry of the plan unless a clear case to the contrary can be established.

The tax reform measures to be introduced in the coming year are:

- A single nominal rate of personal income tax to apply from 1 October 1988.

- The removal of most personal tax rebates and deductions. Alternative funding support to be provided for charitable organisations presently benefiting from concessions relating to gifts and donations.

- The introduction from 1 October 1988 of a guaranteed minimum family income for all full-time salary and wage earners with children, combined with significant assistance through tax rebates for other low-income working individuals and families.

- An increased deduction for child care expenses.

- A reduction in the tax rate on companies to an internationally competitive rate comparable to, but not less than, the personal tax rate.

- Full imputation of dividends to be introduced from 1 April 1988.

- Superannuation funds and life offices to be subject to tax from 1 April 1988.

- Remaining personal and employer concessions for superannuation contributions and life insurance premiums to be removed from 17 December 1988.

- Superannuation lump sum and pensions benefits to be exempt from tax from 1 April 1989 following renegotiation of the scheme.

- Measures to combat tax avoidance by the introduction of a stringent regime for international tax, subjecting tax-exempt organisations to tax, and the introduction of a new regime for petroleum miners.

- New arrangements for the payment of provisional tax, including penalties for underestimation and late payment.

- Introduction of new withholding taxes on interest, foreign-sourced dividends and payments to resident contractors.

- Removal of concessions affecting the collection of GST by non-profit bodies.

- GST-registered traders with a turnover exceeding $24 million to submit monthly GST returns from 1 April 1988.

- GST rate to be increased by 2.5 percentage points to 12.5 percent no earlier than 1 October 1988, and to be accompanied by tariff reductions and a $200 million cut in excise duties on fuels.

Consultative documents on full imputation, superannuation and life insurance released. Other measures include:

- Competition in the telecommunication industry.

- A review of local government structure.

- A review of professional and occupational group monopolies.

28 January 1988 Economic Package Deferred

The Prime Minister announces the deferral of the new flat personal tax rate and the new low-income support measures that had been announced on 17 December 1986.

1 to 10 February 1986 Further Deferrals

The Prime Minister and Minister of Finance make a number of statements deferring or abandoning aspects of the 17 December Economic Statement.

10 February 1988 Revised Economic Package

The Minister of Finance makes an economic statement in relation to the 17 December 1987 and 28 January 1988 announcements, detailing which proposals will proceed.

Business and Company Tax Reform:

- The rate of tax for resident companies for 1988/89 to be 28 percent, and for non-resident companies 33 percent. Other tax rates and rebates aligned with the company tax rate to be adjusted accordingly.

- Legislation implementing the announced changes to the assessment of provisional tax and the taxation of co-operatives and producer boards to be introduced early in 1988.

- The rate of the Fringe Benefit Tax for employer superannuation contributions to be 24 percent.

- Tax deductions relating to donations to be abolished from 1 April 1988.

- Removal of tax exemption for sporting bodies to be deferred until 31 March 1989, to allow time for interested parties to make submissions to a committee considering this and other issues.

- The process of consultation and implementation for the international tax and company shareholder imputation proposals to proceed as announced.

- The rate of tax for life offices to be determined following consultation.

Indirect Taxation:

- The proposed $200 million cut in excise duties on fuels from 1 April 1988 to be postponed and reconsidered.

- As announced, GST not to be increased before 1 October 1988.

- The one-month return period for registered traders with a turnover exceeding $24 million to proceed from 1 April 1988.

- GST base-broadening measures to treat business activities of non-profit bodies in a similar manner to other registered traders to be deferred until 1 October 1988.

Personal Tax:

Personal tax rates and other related tax rates for the 1988/89 income year to be based on the following measures and to take effect from 1 October 1988:

- The scale of marginal personal tax rates to be 24 percent up to $30,875 per annum, and 33 percent above that level.

- In addition, a rebate of 9 percent of taxable income up to a maximum of $855 in a full year, abating at 4 cents in the dollar between incomes of $9,500 and $30,875. [Note: eligibility for the rebate has yet to be finalised.]

- Consequential adjustments to be made to the national superannuation surcharge and Family Support. These adjustments to maintain the present net position under these schemes.

- The charitable donations and school fees rebate, and dependent relative rebate, to be abolished from 1 April 1988.

- The deduction for most employment-related expenses to be abolished from 1 April 1988.

- The present housekeeper rebate to be enhanced and expanded to bring in a wider range of childcare expenses. [Note: details have yet to be finalised.]

16 March 1988 The Taxation Reform (No. 3) Bill Introduced

The following measures are announced:

- Retention of tax rebates for charities (but not school fees) for a further year.

- Abolition of stamp duty on financial instruments, shares and residential property.

24 March 1988 Income Tax Amendment Act 1988 and Tax Amendment (No 2) 1988 Receive Royal Assent

These amendments pass into law the removal of personal rebates and exemptions for personal and employer superannuation contributions. Changes to accrual rules and farm tax rules are also included, along with a range of miscellaneous amendments.

25 March 1988 Report of the Consultative Committee on International Tax Measures Released

Proposals of the Report reduce opportunities for tax avoidance and deferrals of New Zealand tax by New Zealand residents through the use of offshore entities.

30 March 1988 **Consultative Document on Superannuation and Life Insurance, Vol. 2, Released**

15 April 1988 **Report of Consultative Committee on Full Imputation Released**

28 July 1988 **Budget**

The Minister of Finance delivers the Budget for 1988/89. The Budget confirms many of the measures amended by the February announcement. In particular, it confirms the intention to introduce capital gains tax, to develop proposals for interest withholding tax and to extend this to domestic dividends while deferring the contractors' withholding tax. Tax measures announced include:

- Introduction of legislation to remove concessionary depreciation treatments of commercial buildings and to stop rollover of depreciation for replacement assets.

- Withdrawal of standard value scheme for stocks of wine, whisky and brandy.

- An increase in the excise duty on tobacco production from 90 to 105 percent from budget night. Further increases to 120 percent and 135 percent to take effect from 1 January and 1 April 1989 respectively.

The Budget forecasts a $2,261 million fiscal surplus (3.6 percent of GDP) for the year ended March 1989, aided by a $2000 million target for asset sales. A net financial deficit of $1383 million (2.2 percent of GDP) is forecast.

Also on this date **Income Tax Amendment (No 3) 1988 receives Royal Assent**

This Act introduces:

- A new system of provisional tax estimation.

- New personal tax rates and consequential changes to rebate to take effect from 1 October 1988.

- Changes to the taxation of retiring and redundancy allowances.

- Special provisions to facilitate the winding up of shell companies in advance of dividend imputation.

30 July 1988 Income Tax Amendment (No 4) receives Royal Assent

The Act implements a Budget announcement to allow recovery of excess depreciation on sale of a building and to end the practice of offsetting excess depreciating recovered against the cost of a replacement asset.

4 November 1988 State-Owned Enterprises Minister Richard Prebble Dismissed from Cabinet

The dismissal takes place amid controversy with the Prime Minister over the handling of SOE asset sales. Financial markets greet the news by marking down the New Zealand dollar (from 62.90 USc to 62.00 USc) and five-year government stock (from 13 percent to 13.37 percent).

14 December 1988 Finance Minister Roger Douglas departs from Cabinet

Douglas's departure occurs amid continuing controversy with the Prime Minister over the handling of economic policy. Health and Deputy Finance Minister David Caygill is appointed to the portfolio.

16 December 1988 Income Tax Amendment (No 5) 1988 receives Royal Assent

The No. 5 Act is the major piece of tax legislation for the year. The following measures become law:

- Full imputation regime for company-shareholder taxation to replace the previous classical system of double taxation of dividends.

- New international tax regime to subject controlled foreign corporations (and trust) to New Zealand tax. Also changed are residency rules.

- New rules affecting the payment of provisional tax.

- A new regime for the taxation of trusts.

Between 1984 and 1988 New Zealand's Fourth Labour Government undertook the most comprehensive revision of economic policy which the country had ever seen.

Subsidies were abolished, the tax system reformed and state-owned enterprises moved steadily down the path to privatisation.

The process became known as "Rogernomics" after the Minister of Finance, Roger Douglas. Douglas became Euromoney's "Finance Minister of the Year" and an internationally admired economic reformer. At home his policies proved more controversial. Although Labour was convincingly re-elected in 1987, a year later the consensus behind Rogernomics collapsed. Roger Douglas and two other ministers left an increasingly divided administration. A major struggle over economic direction lay ahead.

Nonetheless, the face of the New Zealand economy had changed irrevocably. In this book, influential analysts, journalists and participants in the process of reform examine the events and impact of Rogernomics.

Rogernomics: Reshaping New Zealand's Economy 1984-88 is an account of an individual's determination to effect change in the teeth of political opposition and institutional inertia.

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