THE NEW ZEALAND ECONOMIC REFORMS

An analysis prepared by
the Hon Ruth Richardson
New Zealand's Minister of Finance
1990 - 1993

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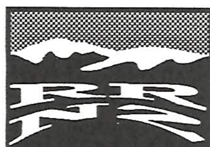
NEW ZEALAND PRIOR TO 1984

By 1984, New Zealand was without question the worst performing economy in the OECD. Our poor performance had been especially apparent over the ten years since the first oil shock in the mid-seventies. But in reality New Zealand's poor relative performance had been apparent for much longer. Productivity growth had been slower in New Zealand than in most other OECD countries ever since the second world war. Over the quarter century to 1984, New Zealand had the lowest rate of productivity growth of any country in the OECD. Over the same period, New Zealand had the lowest growth rate of output per head, and the lowest growth rate of exports. We had also achieved the highest rate of debt build-up, in both government and external debt, and by 1984 were running the biggest current account deficit of any country in the OECD. Inflation in New Zealand had also been higher, on average, than inflation elsewhere in the OECD.

From having the fifth highest living standard in the OECD in the early 1950's, New Zealand by 1984 had slipped to 25th place. Even unemployment - long the favourite indicator of those who argued that the New Zealand economy "worked" - had started in the mid-seventies to trend upwards from its historically very low level.

The most fundamental causes of New Zealand's failure were micro-economic. New Zealand was an economy that used resources very poorly. We were internationally competitive only in a limited range of products, most of which were bulk export commodities. The remainder of the economy was very inefficient by international standards - an inefficiency that stemmed from misconceived policies of regulation and protection. In no other OECD country were market forces allowed such limited scope, and economic decisions so distorted by government intervention.

One of the worst examples of interventionist economic policies was New Zealand's industrial relations system. This system involved occupation-based national awards covering wages and conditions. Each award was negotiated centrally, and constituted minimum conditions binding on all workers of that occupation throughout the country. There was hardly any ability for individual employers or workers to opt out of the conditions struck in the national award. Along with Australia (which still suffers from essentially the same industrial relations model), New Zealand had perhaps the most inflexible labour market regime in the western world.

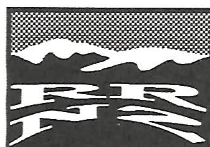


In the late thirties and forties other policies were put in place to turn New Zealand into the most insulated economy in the OECD. Exchange controls were introduced. Very high tariff levels were combined with a system of import licensing for manufactured goods. The object of the policy was to build up the New Zealand manufacturing sector behind a protective wall. But the result was predictable: with a guaranteed home market, the incentive on New Zealand manufacturers was to be inward-looking and to avoid risk-taking. For most of the post-war years, the manufacturing sector was characterised by limited research and development, poor capital stock, inflexible work practices, and overmanning. Manufacturers attempting to export faced a high domestic cost structure, the product both of high import protection and a raft of regulatory burdens on the domestic economy.

The government itself had also become involved as owner and operator in a wide range of business activities. Government trading organisations were inefficient - often grossly so - and suffered mixed or unclear objectives. Some were effectively employers of last resort. Government businesses thus formed a substantial component of the protected sector.

During these years New Zealand badly lagged other countries in investment in post-school education and training. The implicit signal to young New Zealanders was that skill acquisition was not greatly rewarded. Wage differentials were narrow, with little premium for skill. Unskilled jobs were freely available. Also discouraging human capital development was an increasingly generous welfare state, which reduced the incentive on New Zealanders to provide for themselves through their own efforts. As time went on, escalating marginal rates of personal income tax, and an overall tax burden disproportionately falling on direct rather than indirect tax, further discouraged work effort and the investment in skills.

From the 1960's onwards New Zealand also saw increasingly poor macro-economic management. The government was often running significant fiscal deficits, adding to a savings-investment imbalance which was reflected in the current account. Monetary policy was becoming increasingly expansionary. In the mid-seventies the New Zealand economy was hit by the two shocks that accelerated its relative decline - the first oil shock and the entry of Britain into the European Economic Community (as it was then called), which substantially curtailed New Zealand's export markets. The actions taken by successive governments were reactive and ad hoc. A variety of new export subsidies were devised for both manufacturers and farmers. Some progress was made in developing new export markets. However, subsidies to exporters put considerable strain on government finances, exacerbating the large fiscal deficits of the late seventies and early eighties, and the rapid build-up of debt.



In 1982 the focus of macro-economic policy was switched to inflation, with the announcement of a comprehensive freeze on wages and prices. By 1984 - an election year - both fiscal and monetary policy had turned expansionary. The calling of a snap election for 14 July 1984 led to a drain on New Zealand's foreign exchange reserves. The election was won decisively by the Labour opposition. When the foreign exchange market opened straight after the election, the drain on New Zealand's foreign exchange reserves turned into a full-scale run on the dollar.

Thus the new government inherited a foreign exchange crisis, a very badly performing economy, and a set of economic policies of singular ineptitude.

OVERVIEW OF THE REFORMS

The New Zealand economic reforms spanned a period of almost exactly ten years. The first initiatives were taken in July 1984, and the last major reform was completed when the Fiscal Responsibility Act went through its final stages in the House of Representatives in June 1994. Two administrations share the credit for the reforms. The first was the Labour government that took office in July 1984, was re-elected three years later, and then lost office in November 1990. The incoming National administration (New Zealand's "conservative" party) gave new impetus to the reforms, and was re-elected in November 1993.

The New Zealand reforms were unprecedented in scope anywhere in the western world, and presented the sharpest contrast with the policy regime of the past. The key principles driving the reforms included:

- The abandonment of current account balance as a *direct* objective of government policy

- The abandonment of fiscal policy as a means of short-term fine tuning, and instead the adoption of a medium term fiscal strategy aimed at controlling government spending and eliminating the deficit.

- The assignment of monetary policy to the sole objective of achieving, and then maintaining, price stability

- An abandonment of the use of economic policy instruments for *distributional* objectives, and an acknowledgment that concerns over income adequacy, or over the distribution of income, are best addressed explicitly through the tax and benefit system

- A new emphasis on the value of competitive markets and the role of the price system in the efficient allocation of resources

- A determination to expose New Zealand business, where possible, to international competition, without subsidies, tariffs or other artificial barriers

- A belief that the tax system should be as neutral as feasible between different types of activity

- A distinction between the State's role as an ***owner*** as contrasted with that of a ***purchaser*** of goods and services on behalf of citizens.

- In all areas of policy, a concentration on the medium term implications of policies rather than their short term effects

At the heart of the reforms was a recognition that resources had not been well employed in New Zealand, and that only by exposing industry to market forces and to much greater international competition could we transform New Zealand's economic performance. There was thus a strong philosophy of economic liberalism: free markets were seen as the chief engine of medium term economic growth. There was also an appreciation that the excessive short-term focus of macro-economic policies had been severely damaging to the economy. Monetary and fiscal policy needed to be disciplined in a way that was consistent with a sustainable medium term growth objective.

One of the most distinctive features of the New Zealand reform programme was its concern with the concept of "government failure", as understood by theorists of the public choice school. In general, governments can be expected to act in their own self-interest; there is no guarantee they will follow policies that maximise the overall welfare of their citizens. In New Zealand there was a search among policy makers for institutional rules that would bind governments, as much as possible, to sound macro-economic policies, even when the short-run incentives of governments are for unsound policies. Measures such as the Reserve Bank Act and the Fiscal Responsibility Act can only be understood in this context.

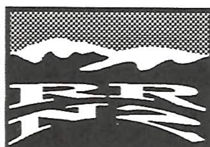
The key initiatives of the decade of reform can be summarised as follows:

- The floating of the New Zealand dollar

- Deregulation of the financial sector, including the abolition of exchange controls, the lifting of interest rate controls, the abolition of reserve asset ratio controls on banks and the development of a new regime of prudential supervision

- The Reserve Bank Act, conferring price stability as the primary goal of the independent Central Bank's management of monetary policy

- The introduction of a flat-rate value-added tax (GST), cuts in marginal income tax rates, and a series of measures to broaden the tax base and eliminate anomalies in the tax system



- The introduction of freedom to contract in the labour market through the Employment Contracts Act

- The elimination of most direct subsidies to both pastoral and manufacturing exporters, the phasing out of import licensing and the substantial phased reductions in tariffs toward low or zero rates

- Other deregulations, including the removal of a number of specific price controls, the liberalisation of air services and coastal shipping, and the introduction of competition into electricity and telecommunications

- Reform of social transfers with the aim of containing costs and concentrating government assistance on the needy

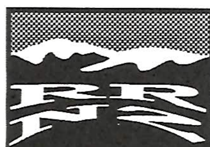
- A series of measures to bring greater focus, discipline and transparency to government spending, including the State Sector Act, the Public Finance Act and the Fiscal Responsibility Act

- The corporatisation - and in many cases privatisation - of state trading activities

- Modernisation of the core state sector with decentralised management and results based personnel and financial reporting systems

- Separation of the funding from the provision of many services - eg health and science

Some of these reforms are by no means unique to New Zealand. In many areas, however, New Zealand has been a pioneer. For instance, the Reserve Bank Act, and the series of public sector reforms culminating in the Fiscal Responsibility Act, show New Zealand to be a world leader. New Zealand has also achieved one of the freest labour markets of any OECD country, as well as the least distorted tax system.



EARLY REFORMS

The initial pace of the New Zealand liberalisation programme was rapid. Before the new Labour Government had even been sworn in, it had moved to devalue the exchange rate by 20%. At the same time, it lifted all controls on interest rates. These measures were sufficient to diffuse the government's immediate crisis - the run on the New Zealand dollar.

A succession of initiatives followed to liberalise financial markets. The system of reserve asset ratios applying to financial institutions was abolished. Monetary policy henceforth operated, not by direct controls on individual banks, but by controlling the amount of base liquidity in the total financial system. All exchange controls were abolished. Then, in March 1985, the New Zealand dollar was floated. Ever since then, the Reserve Bank of New Zealand - our central bank - has run a "clean" float: there has been no buying or selling on the foreign exchange market with the intention of directly influencing the value of the New Zealand dollar.

Floating the currency had two principal motives. It assisted monetary policy by giving the authorities better control over the monetary base than is possible under a fixed exchange rate regime. There was also a belief that a floating exchange rate had an important role to play in resource allocation. Like other prices, it is a mechanism through which important signals are transmitted to participants in the economy.

The exchange rate float has been successful in gaining independence for monetary policy. In the early years of the reforms, however, it is questionable whether the floating exchange rate assisted overall resource allocation. This was because of the imbalances elsewhere in the reform programme.

The opening months of the reform programme saw major cutbacks in industry assistance, with the biggest reductions in the area of agricultural subsidies. Despite the previous government's attempts to diversify the export base, primary products in 1984 still accounted for around two thirds of total export earnings. Direct assistance to both pastoral and manufacturing exports was now rapidly phased down. The scaling back of import protection proceeded at a much slower pace. Though import licensing was being phased out, tariffs remained very high by international standards during the early phase of the reforms.

Tax reform in New Zealand was of consistently high quality. The tax structure inherited in 1984 had been heavily reliant on direct rather than indirect tax, had contained numerous loopholes, and - unsurprisingly - had resulted in very high marginal rates of direct taxation. The new government introduced a flat rate value-added tax on virtually all goods and services. Goods and Services Tax (GST) replaced the existing varying-rate sales tax, and allowed marginal rates of income tax to be substantially cut. Difficult to evade, easy to comply with and even in its incidence, GST proved a model of tax reform. Other reforms were also made to broaden the tax base and eliminate loopholes.

Another highly successful reform was the revamp of many government trading activities into state-owned enterprises (SOE's). Formerly inefficient and unaccountable organisations were transformed into companies facing a single main objective - profit maximisation. The environment for the new SOE's replicated, as much as possible, the environment faced by private companies. As a result of these new incentives, large efficiency gains were rapidly achieved by virtually all of the SOE's.

Gaining control over the huge inherited fiscal deficit proved a much more difficult task. The government's initial moves to scale back industry assistance yielded important savings. Also fiscally positive - as well as justified on its own terms - was the move to price government-provided goods and services on a more economic basis. Other fiscal savings proved harder to achieve, with the result that the deficit remained too large in the early years of reform. Inflation was climbing after the freeze, given impetus by the high post-freeze wage rounds and then by the one-off introduction of GST. Monetary policy over this period had tightened considerably, having adopted an explicitly anti-inflationary stance. The combination of tight monetary policy and much looser fiscal policy saw high real interest rates and upward pressure on the real exchange rate for much of the period 1985-1987. The high real exchange rate was not assisted by the slow pace at which import protection was being reduced relative to the fall in export assistance, nor by the removal of the wage freeze without accompanying measures to tackle institutional monopolies in the wage setting process.

THE MIDDLE PERIOD OF REFORMS

The second term of the Labour Government - re-elected to office in August 1987- is generally regarded as a period in which the momentum of reform slowed. While this may be true, and while economic policy over this period never succeeded in ridding itself of all imbalances, reforms were still pushed ahead on a number of important fronts: further reductions in import protection; a substantial privatisation programme; and key institutional reforms in both monetary and fiscal policy, as well as fundamental restructuring of the core state sector. This progress was made despite an increasingly difficult economic environment: output was stagnant over the calendar years 1988-1990, while unemployment rose strongly as employers rationalised their labour forces in response to weak demand and new competitive pressures. This period saw the focus of economic adjustment shift from the rural to the urban economy.

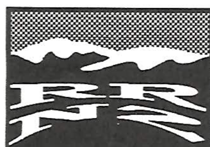
Early in its second term the government announced it would undertake an extensive privatisation programme. The government owned many businesses suitable for sale, and the corporatisation process had added substantially to this pool. Over the next three years the government sold almost $10 billion in assets, mostly by open tender, including the sale of New Zealand Telecom. The corporatisation of government trading activities also continued.

Faster progress was now being made in reducing import protection, particularly through the announcement of a staged reduction in tariffs for most goods, in five steps, between 1988 and 1992. This programme brought tariff rates down by a further 50%, on average, with higher rates falling faster than lower rates. The government also continued its programme of tax reform. By 1989 the OECD was able to say that New Zealand's tax system was "probably the least distorting" of all its member nations - a statement that remains true today.

Inflation fell rapidly in the course of 1988, in response to the tight monetary policy that had applied since 1985. But the disinflation process was not yet over. To further reinforce the credibility of its monetary policy the government announced a target of 0-2% inflation by 1992. More importantly, in 1989 the government passed the Reserve Bank Act, which transformed the institutional environment under which monetary policy operated.

The Reserve Bank Act was motivated primarily by a concern to reduce the potential for monetary policy to be misused-used by politicians for short-term ends, as had often happened in the past. The Act placed the Reserve Bank onto an autonomous but accountable footing. The Act recognised that, in the medium term, inflation is the only economic variable capable of being controlled by monetary policy. Accordingly, the Act specified price stability as the principal objective of the Reserve Bank, while the bank was made accountable to parliament for its performance in pursuit of that objective. There is provision in the Act for the government of the day to temporarily override price stability as the primary goal of the Reserve Bank, but any such instruction from a government must be made public. The public nature of the override makes it very unlikely that any government would make such a move. The Act thus constitutes a powerful mechanism for reinforcing the credibility of monetary policy.

On the expenditure side, major changes were occurring to the way in which core governments managed their resources. Previously government financial management had been highly centralised, and had largely consisted of accounting for inputs. Departmental objectives and responsibilities were blurred at best, and departments had very little autonomy over the way money was spent. This situation changed markedly with the State Sector Act (1988) and the Public Finance Act (1989), which improved both the focus and the culture of government departments. Departments were now required to specify their outputs. Ministers were able to choose which outputs they wished to "purchase" from their departments. Departmental chief executives were put onto five year contracts, and became directly responsible to their ministers for delivering the chosen outputs. Chief executives also gained much greater operational flexibility in their use of inputs, so could now be genuinely held accountable for their department's performance. The new system not only provided much better incentives for efficient resource use. It also allowed ministers to assess priorities, and to make informed trade-offs over which departmental outputs they wished to purchase.



Despite the improvement in the institutional environment for conducting fiscal policy, the government still struggled over this period to contain the budget deficit; any progress achieved was made through increasing tax revenue rather than reducing government spending. Expenditure on social programmes was expanding, partly owing to the cyclical downturn in the economy, and the fiscal deficit remained a problem right through the second term of the Labour Government. Both fiscal and monetary policy were still putting pressure - albeit reduced - on the real exchange rate. Along with fiscal policy, the failure to reform the labour market remained an anomaly in the reform programme, as did the still high - though falling - levels of import protection.

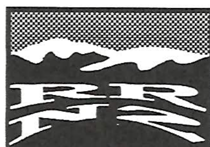
FINAL ROUND OF REFORMS

The final round of reforms was undertaken by the National Government, elected to office in October 1990. The government's initiatives removed the last substantive imbalances in the reform programme, and put New Zealand into a position to enjoy sustainable economic growth.

One of the most important initiatives of the entire decade of reform was Employment Contracts Act (1991), which transformed the rules by which the labour market operated. The Act abandoned the antiquated system of national awards that had so long prevailed, and instead provided, in large measure, for freedom to contract in the labour market. In so doing, it turned New Zealand from having one of most inflexible labour markets in the OECD to having one of the freest and most flexible.

Under the Employment Contracts Act, there is very little proscription of the types of contracts employers and workers can enter into. Workers can be covered by a collective contract or by an individual contract. Employers can negotiate a mixture of collective contracts and individual contracts with their workforce. Union membership is no longer compulsory. A worker is free to choose his or her own bargaining agent when negotiating with their employer. Strikes are seen by the Act as a breach of contract, and are only permitted where they relate to the negotiation of a collective contract for the employees concerned. All other types of strike - including sympathy strikes - are unlawful.

While both collective contracts and individual contracts are permitted under the Act, it does not favour one type of contract over the other. The essence of the Act is choice. Whether to have a collective or an individual contract is itself a matter for negotiation between employer and worker. There is little to stop any individual worker coming together with any individual employer and striking their own deal, if that is what the two parties desire.



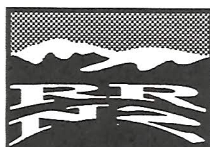
The National government continued the programme of other micro-economic reforms undertaken over the previous six years. More state assets were privatised, including the Bank of New Zealand - the country's largest bank as well as the State owned rail company. In 1991 a further global tariff reduction programme was announced, in which tariff rates would be cut in four stages by a total of around one third, from 1993 to 1996. In 1994 the government announced another staged fall in tariff rates.

The government also made major reforms to social spending. The principles driving these reforms were fairness and affordability. Social welfare benefits were cut, abolished or more tightly targeted, both in order to achieve fiscal savings and to increase the margin between earnings in the workforce and earnings from a benefit. Housing assistance was rationalised so that people in equal circumstances were treated equally, with the tax system used to deliver an accommodation supplement or voucher. The public health system was restructured so as to separate out the funding of health services from their provision. Substantial savings were made through changes to New Zealand's state pension scheme, and a multi-party agreement was reached on its main parameters. These and other savings lead to a substantial fall in government spending, from 39% of GDP in 1991/92 to under 35% by 1994/95. In 1993/94 New Zealand achieved its first fiscal surplus for a generation.

That year the government also passed the Fiscal Responsibility Act (1994). This Act sets down in legislation extensive and rigorous criteria for fiscal reporting. Already New Zealand had been the first country in the world to develop a full balance sheet for its central government, and an operating statement on an accrual basis. The new Act formalised these, and other, elements of government financial reporting into law. It also required the government to publish a full economic and fiscal update just prior to each general election, so that no government could hide from the electorate the consequences of irresponsible fiscal policy. New Zealand now has the most complete and open fiscal reporting of any country in the world.

The Fiscal Responsibility Act goes further: it requires the government to conduct fiscal policy in accordance with a set of "principles of responsible fiscal management". These principles include reducing government debt to "prudent" levels and, once prudent debt levels have been reached, running budgets that are roughly balanced over time. Any departure from these principles by a government must be temporary. It must also be entirely transparent - the government is compelled to explain publicly why it is not conducting policy in accordance with the principles of responsible fiscal management, and how it intends to return to those principles.

The Fiscal Responsibility Act thus provides a powerful discipline on New Zealand governments. It does so without falling into the trap of imposing overly simplistic rules, and without compromising any government's right to set its own priorities in fiscal policy. The Act largely completes the series of reforms that have, since 1984, transformed the framework of the New Zealand public sector. In the opinion of Economist magazine, the Fiscal Responsibility Act, together with the Reserve Bank Act, gives New Zealand the best macro-economic policies of any country in the world.



SEQUENCING

While the New Zealand reforms were unparalleled in their scope and quality, at least in the OECD, the sequencing of the reforms was far from perfect. A general consensus on the optimal sequencing of reforms might be summarised as follows:

- Macro-economic stabilisation should, if possible, take place early. The government should move rapidly to control the fiscal deficit. If not, poor macro-economic policy will compromise the gains made in the micro-economic reforms.

- Domestic markets - both in goods and in labour - should be deregulated, as much as possible, no later than the reduction in border protection. This will provide import-competing industry with the environment most conducive to competitiveness, before exposing it to international competition.

- Financial market deregulation should not occur before substantial progress has been made in liberalising goods and labour markets, and before the fiscal deficit has been brought under control. This caveat particularly applies to the foreign exchange market: opening up the foreign exchange market too early risks putting excessive upward pressure on the real exchange rate.

- The broader the scope of the reform programme, and more clearly it is telegraphed, the sooner will the benefits begin to flow.

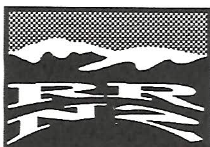
In New Zealand the sequencing of reforms went roughly as follows:

Financial market liberalisation	-	immediate
Goods market liberalisation	-	proceeded in stages, mainly subsequent in time to financial market liberalisation
Government sector reform	-	proceeded in stages, but fiscal imbalances not finally corrected until late in the reform programme
Labour market liberalisation	-	late

Thus two principal mistakes in sequencing were:

- the long time taken to bring the government deficit under control, having already deregulated the financial markets (and in particular the foreign exchange market). This put excessive pressure on exposed sectors of the economy

- the failure to liberalise the labour market early in the reform programme. This compromised the drive to become internationally competitive and resulted in excessively high unemployment during the transition



A third mistake was the uneven pace of goods market reform, in which assistance to exporters was scaled back more rapidly than reductions in import protection. For a time this put added pressure on the export sector.

These sequencing mistakes undoubtedly increased the adjustment costs of the New Zealand reforms.

THE NEW ZEALAND ECONOMY TODAY

Whatever the adjustment costs may have been, there is no question that the New Zealand economy has emerged vastly the stronger as a result of the decade of reform. For the economy as a whole, the turning point came in 1991. That year almost all of the elements of the reform programme began to work to reinforce one another. Inflation fell to 1%. Real interest rates and the real exchange rate fell, as the disinflation process came to an end, and as control was gained over fiscal policy. The Employment Contracts Act made possible major improvements in productivity. An economic upturn began, which gradually gained strength.

Since 1991, the performance of the New Zealand economy has been extremely impressive:

- GDP has grown by a total of 18% in the four years since the upturn began - one of the best growth performances in the OECD.

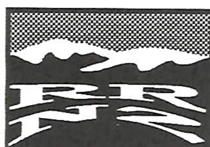
- Labour market liberalisation has proved extremely positive for jobs. In four years and three months since the economic upturn, employment has grown by over 12% - again one of the best performances in the OECD. Unemployment, at 6.1%, is now the third lowest in the OECD, and is expected to fall further.

- The export sector has been flourishing, with a substantial increase in sophisticated, value-added exports. Non-commodity manufacturing exports have grown by around 60% in volume over three years.

None of these results has been achieved through short-term stimulus by the government. On the contrary: New Zealand's entire economic policy framework is geared to the medium term. In particular:

- Inflation has averaged under 2% since 1991, as the Reserve Bank continues to pursue its statutory mandate for price stability.

- A budget surplus of around 3.3 % of GDP is expected in 1995/96, rising to 5.7% in 1998/99. Rapid inroads are being made into New Zealand's debt burden. This is despite a substantial programme of income tax cuts planned for 1996 and 1997



New Zealand business is now confident, innovative and internationally-competitive:

- New Zealand's credit rating [Standard & Poors] has climbed from a low of AA- in 1991 to AA+ in 1996 - a higher rating than Australia's.
- In the latest World Competitiveness Survey, undertaken by the World Economic Forum New Zealand ranks in third place for overall competitiveness
- According to the Heritage Foundation, a US think-tank, New Zealand now has the fourth freest economy in the world
- Transparency International has named New Zealand as the least corrupt country out of 41 countries surveyed

CONCLUSION

A number of lessons can be drawn from the New Zealand experience:

- The value of comprehensive reform. The New Zealand reforms were both micro-economic and macro-economic. They encompassed capital and labour markets, goods markets and the government sector.
- The importance of balance in reform. The New Zealand economy began its period of sustainable economic growth only after the last principal obstacles to growth were removed.
- The importance of correct sequencing. In New Zealand, early liberalisation of the labour market and control of fiscal policy would have reduced transition costs.
- The value of a medium-term focus. All New Zealand's principal reforms had a medium-term focus. Many, such as the Reserve Bank Act and the Fiscal Responsibility Act, are explicitly framed as mechanisms for ensuring good behaviour from governments

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