Briefing to the Incoming Government

1990

NOTE

Unless otherwise stated, all years refer to years ended 31 March.

Data on a fiscal year basis refers to years ended 31 March to 1988/89 and years ended 30 June thereafter.

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CONTENTS

TABLES

FIGURES

1. OVERVIEW

INTRODUCTION

After two years of a faltering recovery New Zealand still faces the prospect of slow growth. The outlook is for rising unemployment, increased debt, and more people becoming dependent on the state or limited in their opportunities. To become a high-income, high-employment economy is a massive challenge. We are off target.

Some of this deterioration stems from adverse events and trends in the world economy, especially in the markets for some of our major exports. Much of it, however, is the consequence of domestic economic and social policies that lack harmony.

Monetary policy and fiscal policy have too often pulled against each other, with undesirable consequences for interest rates and exchange rates. Taxation and various benefits and entitlements have adverse impacts on people's willingness to seek work, save or invest. Policy decisions have left behind problems with incentives and administration which are probably contributing to present social problems.

Labour-market practices have been slow to respond to the challenges of a highly competitive international market place. Reforms of industrial-relations laws and other labour-market regulations have lacked the impetus evident in other areas of policy.

The growth in unemployment has been aggravated by benefit structures that provide little financial incentive for many people to seek employment. Administrative structures have, in some areas, become overloaded in trying to implement complex eligibility criteria. Some reforms have not given adequate attention to the practical problems of implementation which have undermined what were otherwise good policies.

The most pressing consequence of these problems is an alarming fiscal situation. With no change from current policy, it is estimated that the Government will confront financial deficits of $3.7 billion, $4.5 billion and $5.2 billion over the next three years. The consequences of not correcting this situation could be very serious indeed.

The remedy for this fiscal problem lies in improving the overall balance in policy strategy. This raises issues of policy design and the processes of decision-making themselves. Other countries have grappled successfully with the growth of public expenditure. But New Zealand has not developed and implemented a medium-term strategy to set limits on the growth of spending and to force careful consideration of relative priorities and the interactions between various policies.

The new systems of public administration and financial management provide tools for more effective review of expenditure on the operational aspects of Government, but the bulk of Government spending is in grants and benefits. To constrain the growth in these expenditures while holding or increasing the quality of services requires a comprehensive appraisal of existing institutions and policies. All spending is affected, but particularly that in the areas of health, education and social welfare. Otherwise, spending constraints will cause cuts in services.

On the other side of the ledger, the easiest options for raising revenue have been largely exhausted. Extra revenue can only be gained in the short-term by raising tax rates and accepting that this will dampen our low-growth economy.

Solving this fiscal policy problem will require redesigning some benefit policies, industrial-relations laws and other labour-market regulations. Wage bargains that reflect and encourage productivity can promote employment and reduce benefit requirements. Welfare policies that target assistance to the most needy, stop abuse and give weight to incentives to work can also reduce fiscal costs.

A solution to the fiscal problem is a necessary part of a strategy for higher living standards. Progress in a number of other policy areas would also increase the prospects for growth, which, if achieved, would then feed back and help improve the fiscal situation by raising revenue and lowering spending. Therefore, careful attention should be paid to laws and regulations such as those affecting companies, capital markets, resource use, labour markets and international trade. Laws and regulations which unnecessarily weaken the incentives and sanctions for effective business decision-making undermine the prospects for growth and employment.

The incoming Government faces an awesome challenge in dealing with this situation. The fiscal problem is very large and it should be dealt with as quickly as is practicable. The timing of actions should be as fast as is consistent with careful decision-making and sound implementation. Even at that pace it would not be realistic to expect a rapid improvement in economic prospects. Experience shows that significant policy change takes a long time to design, implement, observe in action and "de-bug" before the full benefits come through.

The public's expectations of the speed of improvement in the economy may be too high. It is important to establish realistic expectations of what the Government can expect to achieve and by when. Past experience with policies aimed at quick results suggests that in most cases the outcome is disappointing and the longer-term cost considerable. There are, however, hopeful examples of countries which have set a steady course and generally stayed with it and thereby raised their living standards. Meeting this challenge will call for careful policy preparation, well-designed decision-making processes, leadership and careful explanation.

SITUATION AND PROSPECTS

A weak domestic economy is being compounded by high world oil prices and a weaker international situation. This year the terms of trade are projected to fall by 8%, the economy to grow by 0.8%, and unemployment to increase to around 8%. The current-account deficit is projected to increase to 6.6% of GDP.

Beyond 1990/91 the economic prospects are dominated by the large projected fiscal deficits. On the assumption that the Government continues to target inflation in a range of 0% to 2%, the tensions between monetary and fiscal policy will increase sharply over this period. Major financial difficulties cannot be ruled out.

With existing fiscal policy, the current-account deficit should remain between 5.5% to 6% of GDP. Growth is likely to slow down to around 1.5% per year as the effects of high interest rates work through the economy. Unemployment will remain above 8% of the workforce.

If the projected financial deficits were cut, the impact on the economy would depend on the actual decisions taken and the perceptions of the Government's intentions that were created, in contrast with perceptions if these deficits were not cut. A lower deficit might initially lead to slower growth, and higher unemployment. Some offsets to these negative effects would come from the relative improvement in confidence in government policy. Further, the pressures on interest rates would be substantially less and our current-account deficit would be better as a result. The overall result would be more sustainable policies that support stronger growth over time and lower risk of a very sharp and difficult correction forced by financial markets.

During the past decade several important institutional reforms have been implemented: CER, the Reserve Bank Act, public-sector reform, SOEs and privatisation. These have contributed towards a number of pre-conditions for stronger and sustainable growth being achieved:

- Productivity growth has increased markedly over the past four years.

- For the past two years the rate of inflation (adjusted for GST) has been lowered to around 5%, which is close to the OECD average.

- Domestic prices are now more closely aligned to world prices. This has forced domestic firms exposed to international competition to become more efficient.

- Competitive pressures have increased in areas of the economy not directly exposed to international competition. This is resulting in a wider range of services being available at better prices.

- Improved accountability and stronger incentives for efficiency in the public sector.

However, before better economic performance can be secured a number of difficult problems need to be faced. These include:

- The economy recorded negative growth in the first half of this year, and the short-term outlook is for continued weak domestic demand, higher unemployment and large current-account deficits.

- A very serious fiscal problem exists. As noted above, three-year fiscal projections prepared on the basis of existing policies suggest a 1991/92 financial deficit of the order of \$3.7 billion (4.8% of forecast GDP) and financial deficits of \$4.5 billion and \$5.2 billion in the following two years.

- Net public debt, at 52% of GDP, is high by international standards. It is forecast to fall sharply next year to 43%, mainly as a result of the Telecom sale. However, net public debt is expected to rise again to 53% of GDP by 1993/94 under existing policy.

- Tax revenues have grown strongly in order to finance continued growth in government spending.

- Numerous surveys show that households and firms expect inflation to rise over the next year, despite the commitment of both major political parties to price stability.
- Domestic interest rates are likely to remain higher in the face of the fiscal outlook, current-account projections, and policy uncertainty.
- Unemployment numbers have risen. Around 140,000 people were receiving the Unemployment Benefit as at 30 June 1990, which represents 8.8% of the labour force.
- A serious problem of long-term unemployment is developing. Over 92,000 unemployment beneficiaries have been unemployed for more than six months. As at 30 June 1990, 47% of unemployment beneficiaries (65,000 persons) had been unemployed for a year or longer.

Over the next two years, the prospects for international trade are more uncertain and threatening. World economic growth is slowing more than previously expected. North America, the United Kingdom and Australia face the prospect of recession. Oil prices have been high and volatile over the past four months, international interest rates have risen and agricultural commodity prices have weakened markedly. Considerable uncertainty relates to the outcome of the GATT negotiations in December.

POLICY FORMULATION

Stronger economic performance will depend critically on effective and well-integrated policies. Better decision-making processes will be essential. The way policies are implemented will have important effects on their success.

By their very nature, policy decisions require a change to established roles and in ways of doing things. Many individuals and organisations will feel threatened by such changes and seek to maintain the status quo. Succumbing to these short-term pressures can jeopardise the Government's long-term goals.

There will always be a number of ways objectives can be pursued. In considering alternative policy choices several important considerations should be borne in mind.

Balance

Policy balance concerns the way policies interact. This balance influences who bears the costs of change. It can have significant effects on growth and employment.

Policies that pull against each other raise questions about whether they can be sustained. For example, the current tensions between monetary and fiscal policies cause investors to question the Government's tolerance of high interest rates and to speculate that policy will be reversed.

Ministers can formulate better-balanced strategies if the potential interactions between policies are accounted for when decisions are taken. This is not easy, because it demands policy analysis of a very high quality and information which is very difficult to get. Further, every policy, no matter how well designed, produces unintended side-effects. Inevitably, mistakes are made. It is therefore very important that desired outcomes are known, good information on performance is obtained, and prompt corrective action taken when needed.

Targets

The speed of reform needs to balance three concerns:

- giving people sufficient time to adjust
- the Government's wish to demonstrate a sense of purpose, urgency and commitment
- the desire to achieve the results of change as quickly as possible.

Policy targets need to be realistic if people are to believe them and to change their behaviour as desired. The Government should ensure that people understand what can be expected in the way of results and over what period of time.

Process

Clarity about the key objectives being sought must be at the heart of designing and implementing policy. With Cabinet commitment this provides touchstones for decision-making. Clear accountabilities are needed to ensure that the objectives are accomplished.

Among the most important processes are Budget formulation and the monitoring of expenditure decisions. The Government needs decision-making arrangements that allow it to rebalance its priorities, and to establish new ones, without adding to the overall level of expenditure.

Credibility

The Government can be a powerful source of uncertainty for the private sector. The less confident people are about the direction and stability of policy, then the more cautious they are likely to become. Policies are credible when people believe that they will continue to be applied and that they are compatible with the Government's objectives.

Therefore, it is valuable to express all policy directions consistently and coherently. There should be the appearance of one strategy, albeit with a few variations, rather than several strategies.

It is important to build public support for reform in order to avoid strengthening the hands of those who would pursue sectoral interests above the national interest.

Credibility can be easily lost. Major shifts in policy or disputes within a Government create doubts in the minds of investors about the Government's objectives and its ability to meet them.

It takes time, and usually considerable administration, to implement a policy decision. Choosing clean solutions to policy problems can reduce the time and effort for implementation and also facilitate understanding. For example, the use of the Companies Act to incorporate the SOEs had those advantages over separate legislative incorporation of each one.

STRATEGIC POLICY PRIORITIES

Achievement of high growth and high employment by the end of the decade will depend crucially on the policies followed over the next three years.

Labour-market adjustment lies at the heart of both objectives. Productive employment is one of the most important means by which people gain economic security and self-reliance. Yet employment is put at risk by the high interest rates resulting from fiscal policy being out of balance with monetary policy. Poor regulatory policies that restrain the growth potential of the export sector, and policies that adversely affect bargaining structures, real wages and productivity outcomes, all reduce employment and put pressure on the benefit system.

High rates of growth depend on achieving strong productivity growth in all sectors. Strong growth in internationally competitive activities will be essential. Strong export performance depends not only on the quality of those exports but also on the domestic costs that exporters face. The biases of past policies against exports need to be reversed. This growth will require:

- widespread confidence that low inflation will be maintained together with stable or declining tax burdens. The fiscal deficit and rising public expenditure reduce confidence on these points.

- reducing the costs imposed from the more sheltered sectors of the economy. Here the central and local government sectors are important. Also important are the protections afforded by regulations.

- world-class management skills and a labour force that has become generally better skilled.

High employment will not automatically follow from high growth. Many countries manage strong growth with similar or higher rates of unemployment than New Zealand. Employment growth also depends on the path of real wages for different groups. It depends on reducing existing barriers that discourage people from seeking work and on developing better management and work practices.

Comprehensive reform across a variety of areas over several years will be required if higher future living standards are to be achieved on a sustainable basis. Higher productivity growth can only be induced if strong competitive pressures exist.

Three major policy areas will be critical to our medium-term prospects:

- Fiscal Policy: The financial deficit needs to be moved back into balance. The root cause of the fiscal problem, growth in government spending, should be tackled and reversed. This will need to involve reforms to current social-policy arrangements.

- Labour Market: Regulations and incentives that affect labour-market decisions should be reviewed and changed in order to create a climate that generates higher labour productivity, greater skill acquisition, improved competitiveness and growth in employment.

- Regulatory Policy: Ongoing reforms to regulations are required to ensure that they support strong competition and efficiency. Such reforms should not be biased against a more rapid development of internationally competitive activities.

Policies in all the above areas need to be supported by a stable and consistent monetary policy.

Fiscal Policy

High levels of government spending, taxation and debt impose direct costs on the private sector. They also influence expectations about the future policy and economic environment. A well-designed fiscal strategy will increase the attractiveness of New Zealand as a location for investment and job creation.

Experience both in New Zealand and abroad suggests that the control of public expenditure is more successful in the presence of some overarching target or ceiling. These usually have no sound analytical basis and can be very distorting if interpreted mechanically. It appears, however, that they may play a valuable role in redressing the balance between those proposing spending with a lot of information on their side and those opposing proposals with very little information. Clearly expressed spending constraints may also strengthen the incentives on Ministers to co-operate in setting priorities and sticking to an agreed fiscal strategy.

A variety of potential targets are available and should be considered. A useful general principle might be that the growth in total spending should be kept within the revenues that can be raised by:

- GST set at a rate that does not undermine the acceptability of a very comprehensive base at a single rate

- a personal and company tax system that does not impose on taxpayers high marginal tax rates that reduce their incentives to work, invest and save or have a negative impact on New Zealand's attractiveness as a location for business activity.

Expenditure has not been kept within these limits. The growth in expenditure has required a constantly rising tax burden and now leaves the prospect of a large and unsustainable deficit. The present fiscal outlook shows expenditure continuing to outstrip revenues. Higher taxes on a stagnant economy will only damage the economy further.

The tax system has been broadened and is now seen as one of the most efficient amongst OECD economies. Moves to increase tax rates would increase tensions with other policies. Raising GST would complicate and postpone the attainment of price stability.

Increasing rates of personal income tax alone would result in different tax treatment between individuals and companies. Attempting to overcome this by increasing corporate tax rates would discourage investment. Compliance costs and avoidance would almost certainly increase.

The deficit will not disappear once economic growth accelerates. Many of the forces underlying the projected growth in expenditure result from spending commitments such as debt servicing and entitlements to health and education. These commitments do not change greatly with economic growth.

Reform of current social-policy arrangements is essential if spending is to be contained without the emergence of unacceptable hardships for the least well-off. Such reforms will need to involve:

- greater efficiency in delivery systems

- administrative systems oriented towards getting those able to work back into regular employment

- administrative systems that reduce fraud and abuse

- more vigorous targeting of support to those who really need it, possibly involving changes to benefit relativities and more narrow eligibility criteria.

The scope for efficiencies in health and welfare administration, and to a lesser extent education, are limited under present forms of funding and delivery of services. Attempts to generate large savings in expenditure without further reforms could result in substantial reductions in the level and quality of services, rather than greater efficiency and lower costs.

The reforms embodied in the Public Finance and State Sector Acts provide Ministers with new tools for rational examination of priorities amongst departmental outputs and for reviewing departmental efficiency. The main instruments for achieving these benefits are the performance agreements and work programmes between Ministers and Chief Executives. These enable Ministers to specify objectives, and also establish accountability for departments' performance in implementing policies.

Different policy choices will be appropriate to different types of problem, especially in the area of social expenditures. The best choice in each case will depend on the balance of three factors:

- who has the best information to make a decision
- how best to strengthen the incentives on individuals to make good choices and on institutions to provide good services
- what is the best way for individuals and taxpayers to share risks and costs.

The well-established policies for creating and monitoring SOEs and selling assets for which there is no wider reason for public ownership have an important role in fiscal policy. They contribute also to the wider adoption of better resource management.

The continued growth in expenditure, despite major investments of Ministerial time in expenditure review exercises, points to the need to develop more effective review and monitoring processes. Better fiscal outcomes require:

- a fiscal strategy to be at the centre of the Government's overall policy and political strategy
- review processes that reallocate spending between priorities, rather than increase total spending
- mechanisms for more effective monitoring and control by the Cabinet of the wider and longer-term implications of the decisions they take each week
- mechanisms for more regular information to the public on the medium-term fiscal outlook and the decisions that lie behind that outlook.

Expenditure control can only succeed if there is a clear commitment to restraint. Agreed procedures for establishing spending priorities and proposals for additional expenditure need to be honoured. Such a commitment would reduce the possibility of spending proposals adding to total expenditure by being considered outside of an agreed budgeting process.

Labour Market

Better functioning of the labour market is important if New Zealand is to achieve a high-wage, high-employment economy. Employment is the main means by which most people derive their income and well-being.

The economy's ability to produce more jobs and higher incomes is affected by a number of government policies. Macroeconomic policies underpin the expectations of both employers and workers and, in turn, wage- and price-setting behaviour. Wages and prices are also affected by the degree of competition in the economy. Social-welfare and tax policies influence people's attitudes towards work, training and risk-taking. Education and training policies play a major role in developing the skills, abilities and attitudes of the potential workforce. Finally, the labour market is directly affected by extensive government regulation and government spending on wage subsidies, training and placement services.

The key requirement for the labour market is to reverse the poor record of employment growth and to sustain high rates of productivity growth. The labour market involves complex issues of efficiency and equity. A balance must be struck between protecting the current incomes of those in employment and enabling the creation of more jobs. The current situation provides evidence that the balance should lie more in favour of getting people back into employment, and encouraging more productive working arrangements.

There is a serious mismatch between the number of low-skilled people seeking work, particularly away from the cities, and the jobs that are likely to be available under present terms and conditions.

To break the vicious cycle of rising unemployment and increased benefit dependency, it is important to get those able to work back into jobs. To achieve high employment will involve real wage restraint and in some cases real wage declines.

Centralised arrangements such as the Australian Accord have probably brought about significant real wage adjustments that have assisted their employment growth. Past experience in New Zealand suggests that this would be a high-risk approach. New Zealand has a history of poor experiences with incomes policies. They have been difficult to enforce. They needed back-up from other controls and regulations. They have compromised other policy instruments, especially fiscal policy (e.g., through wage-tax trade-offs). They have seriously distorted relative prices, which play a crucial role in reallocating resources. Acceleration of price and wage inflation occurred once incomes policies were lifted.

Real wage declines can be brought about by an exchange-rate depreciation - possibly associated with an easing in monetary policy. For this to lead to long-term growth and employment, wage and price setters must not recoup the higher costs that result from a lower exchange rate. The evidence from devaluations in the 1970s and in 1984 indicated that wage and salary earners were not prepared to accept prolonged cuts in real incomes. The competitiveness gains associated with devaluations over this period tended to be eroded by cost increases within two to three years. While much of the gain from the August 1988 depreciation in the exchange rate was held, this was largely because the stance of monetary policy was maintained while a rapid increase in labour productivity also occurred.

The crucial test for this approach is its effect on competitiveness. Movements in the exchange rate have only transitory effects on competitiveness and may well damage it by locking in higher inflation. Deliberate exchange-rate depreciation is therefore a risky strategy.

The terms and conditions of employment are of prime importance in the relationship between employers and employees. They can influence whether someone is employed at all, and the rate at which productivity improvements can be made and incomes rise. These are conditioned by the bargaining arrangements used in the contracting that takes place between employers and employees. Government policies have their effects on labour market outcomes by impacting on these contracts.

Employers and employees need greater scope to negotiate on all aspects of industrial relations if improvements in employment and work practices are to be generated. This could best be achieved by recasting the labour laws to create rights and responsibilities that enable employment contracts to be established at whatever level suits the parties. Being locked into a national award by law restricts the opportunities open to workers and employers, and their ability to respond to developments within a sector or an individual firm.

Reform to labour-market regulations needs to be supported by changes to social-welfare arrangements. To reduce unemployment the Government must confront the relationship between benefits and wages. It will need to consider administrative reforms that focus more directly on inducing people back to work.

It should not be assumed that fundamental reform will generate rapid improvements in employment and productivity outcomes. The gain will accrue gradually as new and more effective work practices are put in place. Changes in benefit policies, which improve incentives to work, may put downward pressure on real wages for low-skilled workers. If these are supported by changes to labour-market regulations that reduce the barriers faced by the low-paid or low-skilled in getting into work, then increasing levels of skills and higher levels of productivity should lead to rising real incomes over time.

Regulatory Policy

As a tiny distant economy in an integrated world market New Zealand can enhance its competitiveness by adopting superior regulatory regimes. Regulations in important areas like the labour market, resource management law, company law, capital markets and international trade can affect the balance between policies and hence where adjustment pressures are felt. More generally, they affect the scope for competition and risk-taking. They influence the costs of investment, employment and finance.

Regulatory proposals placed before Ministers for approval tend to be exposed to far less scrutiny and evaluation than new proposals for public spending. Both should be scrutinised rigorously and re-evaluated from time to time, since they can impose significant costs on the community. Effective checks and balances need to be built into the decision-making process. These may involve Select Committees, departmental processes, and independent review bodies which are able to expose the effects of various regulations to public scrutiny.

It is important to continue with the current five-year programme of tariff reductions. This provides for the removal of remaining import-licence restrictions by the end of 1992 and the reduction of most tariffs to 10% or less by 1996. Tariff levels in New Zealand are still among the highest in the OECD along with Greece, Turkey, and Australia, and will remain above present levels in most other OECD countries even after the reductions scheduled between now and 1996. Such protection reduces the competitiveness of exporters by adding to New Zealand's overall cost structure.

Accelerating the present timetable for tariff reform or announcing more ambitious tariff cuts would help to improve the competitiveness of exporters and industries which face international competition without assistance. It would reduce the incentive to invest in areas where we are clearly not internationally competitive.

Monetary Policy

New Zealand is constantly exposed to significant and often unpredictable changes in world prices. The way we respond to these is crucial. Our economic prospects would deteriorate if the initial price or exchange-rate changes spread into general wage and price inflation. A stable and consistent monetary policy, supported by other policies, allows the necessary resource changes to occur at less risk to inflation, output, and employment. The current emphasis of monetary policy on the medium-term goal of price stability should therefore be continued. It is important for monetary policy to maintain a consistent focus directed at containing inflation pressures. Setting an inflation target can help. Wage and price setters should come to realise that pricing decisions that are incompatible with the inflation goal will not be accommodated by the Reserve Bank, but are instead likely to put at risk output and employment.

The relationships between monetary policy actions and a specific inflation outcome are not precise or within the direct control of the Reserve Bank. For this reason we see the consistent application of monetary policy and the institutional arrangements surrounding it as being the key elements of policy, rather than any single inflation outturn.

Institutional arrangements matter for long-term credibility. The Reserve Bank Act is an important reform that places responsibility on the Government to be explicit about its monetary-policy objectives. The Governor is obliged to make every reasonable endeavour to meet those objectives and advise Parliament of how the Reserve Bank intends to conduct monetary policy to reach the policy targets that have been set.

In its relationship with the Reserve Bank, the Government should keep in mind that the success of monetary policy in the longer term depends on the credibility and independence of the institution. It helps for people to believe that the Bank has the objective and the means to lean against inflation even if that might occasionally mean short term interest rates that are uncomfortable for the Government. The more this belief is entrenched, as it has been in Germany for example, the less likely it is that the high interest rates are actually needed.

When the new Act has been in place for an extended period, it might be useful to review the experience to see if any enhancements can be made in the structure and operation of monetary policy.

The monetary instruments and indicators used by the Reserve Bank need to be those that can help build policy transparency and consistency. The tools used to deliver a particular policy stance should enable the Bank to signal its view of current monetary conditions and to show that, if a change in the policy stance is required, this change is consistent with the goal of price stability. As a result, the Bank's day-to-day actions should reinforce the medium-term focus of policy.

Monetary policy is not being sufficiently supported by other policies. As a result, both interest rates and inflation expectations are too high. Easier monetary policy and higher inflation would risk a return to the cost-plus pricing practices that were the norm a few years ago. While considerable progress has been made since then, such practices could quickly re-emerge in an environment with easier monetary policies.

CONCLUSION

The following chapters lay out, in more detail, issues in economic strategy which we suggest for consideration by the Minister of Finance. Questions of both substance and process are raised.