FISCAL POLICY AND ECONOMIC GROWTH

MUST NEW ZEALAND REMAIN A LOW GROWTH COUNTRY ?

NEW ZEALAND BUSINESS ROUNDTABLE

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Fiscal Policy & Economic Growth

Contents

FOREWORD v

EXECUTIVE SUMMARY vii

INTRODUCTION AND OVERVIEW 1

NEW ZEALAND'S PAST ECONOMIC PERFORMANCE AND PROSPECTS 5

MAJOR PROBLEM AREAS 8

- The Labour Market 8
- Social Welfare Transfers 9
- Other Benefits 11

IMPLICATIONS OF CURRENT POLICIES 13

APPENDIX: FISCAL TRENDS 15

Foreword

The New Zealand Business Roundtable has supported the broad thrust of the economic policy reforms instituted since 1984, in the belief that far-reaching changes were needed if New Zealand was to wrench itself free from a long record of relative economic decline.

The business community has supported the reform programme in spite of the fact that the burden of adjustment has fallen very heavily on businesses. The Business Roundtable has taken the view that New Zealand can, and should, raise its sights. New Zealanders have always aimed for the best on the sports field, as the success of the Commonwealth Games so well illustrates, and excellence should be encouraged in all areas of economic and social life.

In fact, businesses have done much to lift their game. Substantial productivity gains have been achieved during the painful restructuring of the past five years.

But the government needs to lift its game as well. As this report notes, the current fragile outlook for the New Zealand economy reflects the reality of an economic programme that is desperately incomplete.

This report updates our previous analysis of fiscal trends and takes the opportunity of discussing fiscal policy in the broader context of overall economic management. We take up two of the major themes of the last OECD report on New Zealand – the need for further reform in the labour market and the social welfare system.

Our labour market laws compel many people to belong to organisations they do not support, and enormously complicate the process of negotiating terms and conditions of employment which will enable businesses to survive and expand and allow jobs to be created. Our welfare system encourages dependency – for many, a benefit is a more attractive proposition than a job. If we are to revitalise our economy and society, these obsolete labour market regulations and perverse welfare incentives must be changed.

This report points the way to the further changes necessary to continue the process of reform started in 1984. More effort in these areas would do much to restore business confidence in the medium-term outlook for the economy, and increase the attractiveness of expanded business investment and job creation in New Zealand.

Sir Ronald Trotter
Chairman
New Zealand Business Roundtable

Executive Summary

- The government has set ambitious goals for economic growth, inflation, public debt and unemployment levels in the 1990s. On current policies, however, only the inflation and debt level objectives look achievable.

- The current economic outlook bears little resemblance to that pictured in the government's objectives. The depressed level of economic activity at present and the anaemic prospects reflect the reality of an economic programme that is unbalanced and incomplete.

- The latest OECD report pointed to the labour market and the extent of the welfare system as major contributors to declining employment opportunities and rising unemployment, and thus priority areas for further reform. In this report we focus on these two critical areas of policy.

- The consequence of an incomplete reform programme has been enormous pressure on the fiscal position, especially from the growth of transfer payments. Rising government expenditure has led to higher taxation, thereby increasing the burden on those sectors/businesses/individuals managing to earn an income in a very harsh environment. Accordingly the ability of the private sector to expand investment and job creation has been substantially undermined.

- New Zealand's labour market institutions, in concert with some aspects of the welfare system, are the major stumbling block to investment and job creation. Our industrial relations law is gravely deficient: as in no other area of the law, it compels individuals to join organisations (unions) which they may not wish to support, it stops groups of workers from forming unions of whatever size suits them, blocks the formation of new unions, and inhibits employers from initiating changes in bargaining arrangements. The welfare system in many cases makes welfare dependency the rational choice for many people, in preference to accepting low-income employment and gradually acquiring more valuable skills and habits.

- Perversely, some seem to think that both our social welfare system and labour market institutions are beyond criticism. They look with disdain on the decentralised and flexible labour markets overseas which have produced enormous gains in employment through the 1980s, and ignore the well-documented capacity for badly-designed welfare systems to fragment low income households, raise youth and minority group unemployment rates and lock people into welfare dependency.

- Failure to address these problems has led to a deteriorating fiscal outlook on current policies. Fiscal adjustment since 1985 has overwhelmingly depended on raising taxes and government charges, thereby further undermining the ability of the private sector to expand investment and job creation.

- The policy reforms since 1984 have done much to lift New Zealand's growth potential, but much remains to be done. By its reluctance to complete the job of policy reform in New Zealand, the government is hampering the economic recovery New Zealand should be experiencing now.

Fiscal Policy & Economic Growth

Introduction and Overview

The annual government budget statement is traditionally the time when the government restates its economic policy direction, and outlines its economic goals. It also provides an opportunity for the public to assess the strengths and weaknesses of these policies.

In this report, prepared well in advance of the 1990 budget statement, we update our analysis of fiscal trends and take the opportunity of discussing fiscal policy in the broader context of overall economic management.

As far as economic policy is concerned, the main issue facing New Zealanders is this – are we destined to remain a low growth economy? If not, how do we break the mould?

The government appears convinced that the New Zealand economy can do better. The prime minister recently reaffirmed and added to the government's economic goals for the 1990s, previously outlined in the 1989 budget. These included:

- sustainable economic growth in the 3-5% range per year;
- stable prices (0-2% by 1992);
- unemployment below 100,000 by the end of 1992, and halved thereafter;
- interest rates in the 7-10% range; and
- a reduction in public debt to below 50% of GDP.

These are desirable objectives, of course, but despite all the changes that have been made in the past five years, the outlook for New Zealand is still mediocre. At best, we face sluggish growth, well below the OECD average. This is a remarkable under-achievement, given that we have had the benefit of an extremely favourable international environment. The 1980s have seen one of the longest post-war world economic expansions on record, and in the past three years New Zealand's terms of trade have risen by 24%, about an 8% boost to national income. We have not enjoyed the terms of trade advantages experienced during the last year since the 1973 commodity boom.

While the necessary policy changes of the past five years were inevitably going to involve an economic slowdown or recession, much of the decline has been avoidable. The lacklustre state of economic activity at present and the fragile outlook reflect the reality of an unfinished economic programme.

Of the government's goals for the 1990s, only the debt and inflation objectives look achievable on current policies (the interest rate 'goals' are simply a consequence of success in reducing inflation). The recent passage of the Reserve Bank Act is a significant further step on the road to price stability and shows that the government has recognised that sustained inflation is primarily an issue of monetary policy, and has directly addressed the problem. With the underlying inflation rate (i.e. excluding GST) in the 4-5% range currently, the projected

decline to below 2% by the end of 1992 now represents a gradual and quite feasible convergence (a decline of about one percentage point per year) on the longer-term objective of price stability.

However, in respect of the other economic goals, there seems little hope of success on current policies. Given the fundamental nature of the areas in which policy limitations are evident – the latest OECD review of New Zealand pointed to the labour market and the extent of the welfare system as central areas for further reform – the government's economic growth and unemployment targets for the 1990s appear wishful thinking in the face of the social and economic catastrophe of unprecedented unemployment and welfare dependency.

As many reports have indicated – and the OECD report is just one of the more recent – New Zealand's labour market institutions, in concert with some aspects of the welfare system, are the major stumbling block to investment and job creation, and thus to the achievement of the government's goals for a reduction in unemployment.

Except in the very short term, unemployment is primarily a result of the factors influencing the evolution of labour market institutions and incentives. Put concretely, the level of unemployment depends on the ability of workers and employers to negotiate terms and conditions which will maintain the viability of the businesses on which all parties depend, and on the influence of the welfare system on the willingness of people to take available employment options and to develop skills which will, through time, expand those options. That there are failures in these areas of policy is evident from the sustained rise in unemployment, in spite of substantial outward migration, during the past ten or more years.

Not only have these labour market issues not been addressed, but the suggestion that further labour market reform is warranted has been grotesquely misrepresented by some as encouraging a return to some fictional period of wage slavery. The fact is that the state is actually using its coercive powers to keep people out of work. People who would prefer a job at a lower wage to no job at all are denied the opportunity to work by current legislation.

People get what they produce – a low growth economy produces low or declining real wage growth, and vice versa. Perversely, some appear to see virtue in an environment which is spectacularly successful at shifting people out of employment and on to benefits, while the decentralised and flexible labour markets which have produced enormous gains in employment in the 1980s (e.g. in the United States) seem to be regarded with disdain.

Like the labour market, the social welfare system is also regarded by some as beyond criticism. And yet badly-designed welfare systems, by dramatically altering incentives, have in many countries demonstrably contributed to:

- the fragmentation of (especially but not exclusively) low income households;
- higher unemployment rates (particularly for youth and minority groups) ;
- transfers of income from those with a lower to those with a higher standard of living;
- the creation of low-income poverty traps which lock people into welfare dependency.

Those who are concerned about using the social welfare system to do good need to be more aware of the well-documented capacity for good intentions to cause profound harm.

In spite of the entirely orthodox nature of the criticisms of current policy, opponents of further reform have suggested that New Zealand economic policy has already headed off into uncharted waters - that New Zealand has embarked on some reckless experiment.

In fact, while some of the economic policy changes in New Zealand in recent years have been bold by past New Zealand standards, the position we have reached is far from flattering. The reality is that New Zealand has only moved from being one of several 'cot-cases' in the OECD to the status of merely a debt-burdened 'sick' economy. Whichever government wins the next election could legitimately attempt to invoke the feeling of urgency and crisis that was expressed to the nation in 1984.

New Zealand has not been involved in any radical experiment in the 1980s. The path New Zealand has followed is well-worn.

In an international context, most of the economic policies adopted during the past five years are mainstream in nature, and represent the common experience of most OECD countries struggling to cope with fiscal imbalances, inflation and the need to promote more competitive economies. They include:

- the attempt to shift the budget balance from deficit to surplus;
- the focus of monetary policy on containing inflation;
- the liberalisation of domestic markets and the reduction in external protection;
- public sector reform and privatisation;
- moves to flatter, broad-based, tax scales.

Unfortunately, the elements of policy which impinge most directly on job creation and unemployment remain largely in the obsolete category in an international context. These include:

- the return to compulsory unionism, the sharp rise in minimum wages, the preservation of the award structure, and the erection of artificial legislative barriers which limit the ability of employers and employees to develop mutually beneficial negotiating arrangements;
- the continuation or only limited modification of universal state-funded welfare systems in preference to better targeting and private insurance.

The consequence of an incomplete reform programme has been enormous pressure on the fiscal position, especially from the growth of transfer payments. Rising government expenditure has led to higher taxation, thereby increasing the burden on those sectors/businesses/individuals managing to earn an income in a very harsh environment. The overall costs to business of complying with the extended tax net have risen sharply. Accordingly the ability of the private sector to expand investment and job creation has been substantially undermined.

The result is low growth and rising unemployment. This increases the risk that short-term panaceas will be sought in easier fiscal targets, higher inflation targets, a lower exchange rate, or the self-defeating exercise of shifting money away from successful businesses and their employees, and dropping it down the bottomless pit of 'job creation', off-the-job training, and business development/ encouragement schemes.

The difficulties with the fiscal position are, to a large extent, the consequence of policy failures outside the conventional (or narrowly conceived) issues of fiscal policy – i.e. decisions on government expenditures and their financing. The inexorable growth in unemployment benefit payments and in other social welfare

transfers has a momentum of its own. The expenditure growth arises automatically as people shift from the workforce and on to benefits. This is why these broader issues must be addressed in the budget context.

As we commented in our last fiscal policy report, prior to the 1989 budget, 'if the next budget confirms the current indications that real expenditures will rise, funded by further tax increases, then the very fragile economic recovery likely to emerge through 1989 will most certainly be delayed'. The well-documented shortcomings of the current policy stance left the government, in 1989, in a position where, to meet its modest fiscal targets, tax rates had to be raised. The pressures of current policies on the fiscal position have therefore contributed, as we warned last year, to a major short-term setback to the New Zealand economic recovery, with its attendant costs in unemployment.

More fundamentally, on current policies the longer-term outlook continues to look bleak. The social and economic cost is very high indeed. Thus the current policy mix is inherently unstable. As problems mount, the pressure for a U-turn in policy – a retreat to higher deficits, higher inflation, a steadily declining currency, and high outward migration – could become overwhelming.

Thus current policies directly contribute to the high risk premia on New Zealand dollar-denominated assets, which continue to depress wealth via weaker New Zealand asset prices and higher New Zealand interest rates than otherwise necessary. New Zealand's archaic labour market institutions will continue to reduce employment opportunities as investment is directed to activities which use labour less intensively, or to countries where labour productivity is higher relative to its cost. As a low growth country we will continue to suffer from a declining skill base as the skilled emigrate and the numbers on welfare benefits expand.

If the government is serious about its economic goals, the outstanding areas of policy reform must be addressed.

New Zealand's Past Economic Performance & Prospects

New Zealand's poor economic performance in the past twenty years is now well understood. The boxed section on the following page summarises some aspects of that performance relative to the OECD or major country averages – which of course contain many other very poor economic performances. The table also compares New Zealand with some of the better-performing OECD economies – we should keep our aspirations high. Although New Zealand's performance rates poorly in all comparisons, we need also to remember that the United States and many European economies have not done as well as many Asian countries during this period.

The essential points are evident from the table:

- a higher inflation rate than the OECD average;
- a substantially lower growth rate, declining from about 70% of the OECD average during 1967-77 to only 35% during 1978-88;
- very low employment creation in the past decade, resulting in steadily rising unemployment (slowed by strong net outward migration) to a point where New Zealand's unemployment rate is now above the OECD average. These unemployment statistics reflect those actively seeking employment (7.0% of the labour force), whereas those registered as unemployed total about 11.5% of the labour force, indicating that a large proportion of the labour force have accepted semi-permanent beneficiary status and stopped searching for a job;
- in common with many other countries, a serious fiscal problem in the early 1980s, which was belatedly addressed after 1984. However, for most of the major OECD countries, the central government financial deficit is offset by surpluses at the state or local government level, so that, for example, in 1989 the United States general government deficit, as a percentage of GDP, was 2.2% (compared with 3.1% central), and in Japan the general financial balance was in surplus by 1.6% (c.f. a deficit of 1.6% central);
- OECD net debt ratios deteriorated sharply in the 1980s as a consequence of these financial deficits, but New Zealand's deteriorated more sharply largely as a result of the realisation of enormous contingent liabilities in the form of write-offs of major project and producer board debt, and the financial restructuring of state-owned enterprises.

The consequences of this impoverishing record of economic management and sluggish economic performance are evident every year in the debilitating struggle to produce a budget which:

i. addresses the urgent need to produce a financial surplus so as to stabilise and reduce the debt burden; and

ii. finances the unrelenting growth in transfer payments from a welfare system that has expanded vastly in the past decade, and meets the debt servicing requirements of the national debt.

Economic Performance Indicators

	1967-77	1978-88	1989
Consumer Prices (Average % p.a.)			
New Zealand	9.5	12.6	7.2
United States	5.9	6.3	4.6
Japan	8.9	2.7	2.6
OECD	7.1	6.7	4.5
Real GDP (Average % p.a.)			
New Zealand	2.8	1.0	-0.4*
United States	2.7	2.8	3.0 est.
Japan	7.1	4.3	4.8 est.
OECD	3.9	2.9	3.6 est.

* Year to June 1989

	1967-77	1978-88	1989
Employment Growth (Average % p.a.)			
New Zealand	1.9	0.3	-2.0**
United States	2.2	2.1	–
Japan	0.9	1.1	–
OECD	1.0	1.1	–

** Year to September 1989

	1971	1976	1981	1986	1988
Unemployment (% of labour force)					
New Zealand	1.4#	2.1#	3.7*	3.9**	7.0**
United States	5.8	7.6	7.5	6.9	5.4
Japan	1.2	2.0	2.2	2.8	2.5
OECD	3.6	5.3	6.7	7.7	6.7

Census data * OECD data ** Household labour force survey

Net Public Debt (% of GDP)	1971	1976	1981	1986	1989 est
New Zealand	–	12	20	43	47
United States	–	–	19	29	30
Japan	–	–	21	27	19
OECD†	–	20	23	34	33

† Major 14 OECD countries (June 1989 OECD Economic Outlook)

	1981-84	1985-88	1989
Central Government Financial Balances (Average % GDP p.a.)			
New Zealand	-5.3	-3.7	-2.1
United States	-4.3	-4.2	-3.1
Japan	-5.5	-3.0	-1.6
Germany	-2.1	-1.4	-1.3
Major 7 countries	-4.6	-4.0	-2.8

The result of these policies has been a massive rise in the tax burden for those still employed.

Unfortunately, New Zealand's economic prospects are still poor when compared with likely average OECD performance. This outlook is evident from:

- a reasonable consensus amongst economic forecasters of relatively weak economic growth in the next 2-3 years in the range of 1.5–3.0% (not 3–5%), and expectations of continued high unemployment;
- still very weak business investment;
- world financial markets placing a low probability on further substantial declines in New Zealand inflation (i.e. a reasonably high probability on an eventual return to more inflationary monetary/fiscal policies and thus of a weaker currency), reflected in longer bond yields remaining at around 12% in spite of the 0-2% inflation target;
- New Zealand company earnings, on the share market, still being priced conservatively relative to world price/earnings multiples, reflecting a perception of continued modest earnings growth prospects.

It might seem extraordinary that, through a period of strong world economic growth, at a time when New Zealand's terms of trade have reached a peak which has been exceeded in only one quarter in the past fifteen years, and following the substantial programme of structural reform, the economy is not growing strongly, with investment booming.

Investment, however, requires a long-term commitment. This in turn requires that businesses have confidence in:

- the stability of the policy environment; and
- their ability to control costs (of which labour costs are generally the dominant factor) and respond to competitive pressures.

The instability inherent in the current policy mix, and the lack of a broad consensus within both major political parties on economic policy, means that a stable policy environment is by no means assured.

Given New Zealand's industrial relations system – where it is often extremely difficult to embrace best-practice technology and high productivity manning arrangements, or to negotiate industry or enterprise industrial agreements, where it is difficult to formulate long-term contracts with adequate legal redress for non-performance, where industrial disputes in other industries (e.g. the ports) can disrupt contracts and impose heavy costs – it should be no surprise that businesses are loath to commit substantial new investment to the New Zealand market. The investment which does occur will, in the current environment, be cautious and defensive in nature.

Major Problem Areas

Taking up two of the major themes of the latest OECD review of New Zealand, we focus on the way in which a combination of unsatisfactory labour market institutions and a badly targeted welfare system is producing high unemployment and growing welfare dependency, and thus a continuing fiscal problem.

The Labour Market

The 1988/89 OECD review of the New Zealand economy commented that 'despite some changes in labour market practices, it is clear that further changes would assist better labour market outcomes' (p46). To translate the technocratic language of OECD reports, 'better labour market outcomes' means, of course, more jobs and lower unemployment.

The government's moves to establish a more competitive economy – by external trade liberalisation, financial market reform, domestic goods market deregulation, public sector reform, corporatisation and asset sales – with a focus on greatly increased reliance on markets and decentralised decision-making, stand in sharp contrast to its approach to the labour market. The changes in labour market policy have encouraged centralisation, have bolstered the monopoly powers of existing unions in their coverage of workers, and have closed off opportunities for the evolution of alternative negotiating arrangements.

New Zealand businesses are increasingly exposed to the competitive pressures of international markets, as New Zealand's trade liberalisation proceeds and as international currency relativities change. But businesses encounter that competition with the massive handicap of an obsolete system of industrial relations law, a system that encourages the inflexibilities that government policy is, in other areas, trying to remove. In consequence the unemployment problem threatens to become intractable, and a substantial drag on productivity and income growth.

The main features of the current system of labour market regulation inhibiting the evolution of an industrial relations environment more sensitive to the competitive pressures facing firms (and therefore threatening jobs) are the following:

- the 1984 decision to reintroduce compulsory unionism;
- the sharp lift in the minimum wage between 1984 and 1988, from 30% of the average wage to 51%;
- the monopoly power to represent workers conferred on existing unions, with artificial barriers limiting the ability of workers to change coverage (e.g. the right to initiate change is restricted to *existing* unions);
- the exclusive rights to negotiate conferred on unions limits the ability to tailor employment arrangements to the preferences of individual workers, a problem that is aggravated the greater the level of aggregation of workers and employers;
- the poor accountability of unions, a consequence of the limited scope for competition over coverage rights;
- the prevalence of national unions, defined over crafts or occupations;
- a minimum union size of 1,000 members;

- the ability of unions to cite employers out of awards, whereas employers do not have that option.

The Labour Relations Act 1987, which continued or introduced these features of the New Zealand industrial relations environment, was represented as a significant step towards allowing restructuring in employment relations consistent with the restructuring of other parts of the economy. In this respect, it has been an abject failure, with the current unemployment rate its monument.

There have been only limited moves towards enterprise- or workplace- level bargaining. Many employers must still negotiate with several different unions. Workers must now rely on increasingly concentrated unions for representation of their interests. The rigid relativities between national awards have generally been maintained, at a time of unprecedented job destruction.

Current labour market regulations represent a fundamental barrier to a strong recovery in the New Zealand economy. Only with the elimination of compulsory unionism and of the artificial barriers inhibiting competition amongst unions for the right to represent workers, together with the establishment of comprehensive individual freedoms to contract, will New Zealand achieve strong and sustained rates of job creation and productivity growth. These reforms need to be made in the context of a body of sound employment law and a realistic income support system.

Far from moving in this direction, however, the government is now planning to implement an incoherent set of labour market proposals presented under the misleading banner of 'pay equity'.

The proposed employment equity legislation would dramatically compound existing labour market problems. The 'thinking' behind the proposals is totally at odds with the need for flexibility in employment relationships. The justification for the legislation is superficial in the extreme (in that proponents point to male-female wage differentials without any attempt to adjust for the wide range of non-gender related factors which influence wage rates; after such adjustment there are insignificant differences between male and female wage rates). If implemented the legislation will further contribute to New Zealand's spiralling unemployment problems.

Proposals for 'industrial democracy' through legislation and the politicisation of employment relationships - rather than through the trust and cooperation which a freer, enterprise-based system would bring - fall into the same category of outmoded ideas.

Social Welfare Transfers

Most of New Zealand's social institutions are as ill-suited to the 1990s as its former economic institutions. As in other areas, what matters are the incentives people face. The primary objective of social policy should be the creation of an environment where most individuals and families can provide for themselves, coupled with well-designed forms of community assistance to those who need it. Our social welfare system scores badly in respect of the incentives it provides, and in the quality of the targeting of expenditures. As a consequence, the tax and benefit system generates a substantial and costly churning of income from one pocket to another of the same taxpayers.

An outline of the trends in social spending is provided in the appendix on fiscal trends. Other than debt servicing, social welfare transfers have been the major

source of expenditure growth, and thus the major cause of the greatly increased tax burden in New Zealand in the past twenty years.

Social service spending has risen from about 7% of GDP in the late 1960s to about 15% of GDP currently. As a proportion of total net expenditure it has risen from about 25% of government spending to over 40%.

The major components of social spending are, in order of cost, national superannuation ($4.6 billion voted in 1989-90), unemployment benefits ($1.3 billion) and the domestic purposes benefit ($1.1 billion). National superannuation payments now represent more than 7% of national income.

New Zealand's 'cradle to the grave' welfare system has long since ceased to be a virtue and has become a major problem.

The 1988/89 OECD report observed that the state pension scheme is 'unusually generous' by the standards of most OECD countries. National superannuation and all other social welfare transfers, in contrast to most other OECD countries, are financed out of general taxation. The report noted that the qualifying age for pensions was low (60, compared with, for males at least, 65 in most OECD countries). Income replacement levels resulting from the present benefit levels are higher than in most OECD countries and are probably exceeded only in Sweden, another low growth country.

The OECD also referred to data suggesting that 'perhaps 90 percent of NSA [national superannuation] recipients have incomes or receive transfers in excess of the average national wage'. While this figure seems high, the numbers are certainly significant. At the same time such recipients have higher levels of accumulated wealth (e.g. housing) and lower commitments (e.g. family raising) than young people, while items of high consumption (e.g. health care) tend to be heavily subsidised by other taxpayers. In other words present national superannuation arrangements, on average, transfer income from those with a lower to those with a higher standard of living.

The government's planned reforms involve a gradual reduction in the benefit relative to wages, and lifting the age of eligibility between the years 2006 and 2025 from 60 to 65. A loose form of targeting will be maintained via the national superannuitant tax surcharge. According to the government's calculations, this should stabilise the fiscal cost of state retirement income benefits up to the year 2025.

While these are positive moves, they do not address the serious economic, fiscal and demographic problems which New Zealand is facing – and facing now, not in 2006.

The key variables to be reviewed are:

- **the benefit rate relative to average wages** (a suitable transition could involve holding the real value for an extended period, so that real wage growth gradually reduced the benefit in relation to average wages);
- **the age of eligibility** (there appears to be substantial agreement in New Zealand that the qualifying age should be increased to at least 65. However, a number of OECD countries have higher pension ages or are considering raising them and the Royal Commission on Social Policy suggested 68 for the universal component of a pension. Increases in life expectancy and activity rates among older people support the case for a higher qualifying age);

- **targeting** the benefit (closer targeting offers the most scope for reasonably rapid fiscal savings. Universality requires high taxes which discourage work initiative and saving by the younger population, and fosters a welfarist culture. A preferable approach is to target retirement income support on the basis of people's ability to meet their retirement needs from private resources. That suggests targeting on the basis of both income and assets, along Australian lines);
- **transitional arrangements** (policy changes should be introduced in a way that minimises unwarranted disruption to people who are near or in retirement. However, the government's current proposals give far too long a transition – the need for fiscal savings is immediate).

Other Benefits

A pervasive difficulty with social welfare systems is to find ways of giving assistance to the genuinely needy without at the same time so inhibiting incentives that beneficiaries become permanently locked into the welfare system. The primary issues are those of incentives:

- the level of benefits relative to alternative employment options, and the effective marginal tax rates that are experienced as the beneficiary moves back towards financial independence;
- the ease with which a benefit can be obtained, the period during which the benefit is available, and the quality of the enforcement of eligibility rules.

In respect of the unemployment benefit, unless the benefit level is below the relevant market wage that can be achieved by the individual, there will be little incentive to accept employment opportunities. There appear to be substantial poverty traps in the New Zealand benefit system, especially when allowance is made for overlapping benefit entitlements (e.g. housing assistance). Eligibility requirements could be tightened substantially – there seems little case for able-bodied young people to have easy access to an unemployment benefit. The OECD report also noted that the New Zealand benefit system was remarkably open-ended – in most other countries the right to benefits is exhausted after a fixed time period. The fairness of such a rule, however, is related to the availability of job opportunities generated by a freer labour market.

Eligibility requirements for the domestic purposes benefit (DPB) also offer considerable scope for reduced expenditure. The number of people receiving the DPB has risen by nearly 70% since 1984 and spending on the benefit has risen by some 200% in nominal terms. The incentives here are particularly pernicious, encouraging irresponsible decisions about parenthood and family structure, and giving an incentive to separation and welfare dependency. The current DPB provides strong incentives for the parties to family breakup to shift the costs on to the wider community. Divorce settlements and more strictly enforced maintenance should be the primary mechanism of support.

The issues of benefit levels, eligibility and/or targeting apply equally to all components of social welfare spending. The high growth trends in some of the benefit categories (e.g. domestic purposes, invalids and sickness benefits) suggest that the benefit eligibility criteria are exploitable and/or that the incentives to move out of dependence are weak.

The need for better targeting of benefits to those in genuine need applies with considerable force to the family benefit ($265m voted for 1989-90), which now exists as a relic of earlier welfare systems, having little rationale in the context of the guaranteed minimum family income scheme.

A general tightening of welfare benefit eligibility to those in genuine need, including tighter control over terms and periods of eligibility and a reduction in benefit levels below the minimum market options available, would offer considerable scope for improving the incentives of (particularly young) people to develop basic skills, and through time expand their employment options. Such moves would offer large fiscal savings and contribute to reversing the rapidly deteriorating skills, self-regard and motivation of many of those currently on benefits.

Of course many would lose existing support levels. But the point is that in many cases this support is unwarranted. Existing schemes have a range of demonstrably poor outcomes, and the associated fiscal burden, as reflected in rising average tax rates, is contributing to the vicious cycle of low growth and rising dependency.

Implications of Current Policies

There are many areas where improvements in government policy could contribute to substantial improvements in New Zealand's growth prospects. These include:

- in the public sector, decisive action to prune administrative/quango spending (the cost of government administration has risen by 80% in real terms since 1984), implementation of the hospitals Task Force Report to improve the quality of output delivered by the health system, establishing the Accident Compensation Corporation as a state-owned enterprise in competition with private insurers, accelerating the business sales programme (including at the local government level in businesses such as ports and electricity distribution), raising the standards of accountability for public sector management, and implementation of fundamental social policy changes along the lines discussed above;
- in the labour market area, addressing the measures discussed earlier, liberalising immigration policy and dropping plans for employment equity legislation, the 'industrial democracy' proposals and the 'Compact';
- starting afresh with a number of reviews and legislative programmes of uniformly low quality including the resource management legislation and the reviews of securities law, takeover regulation and the Commerce Act.

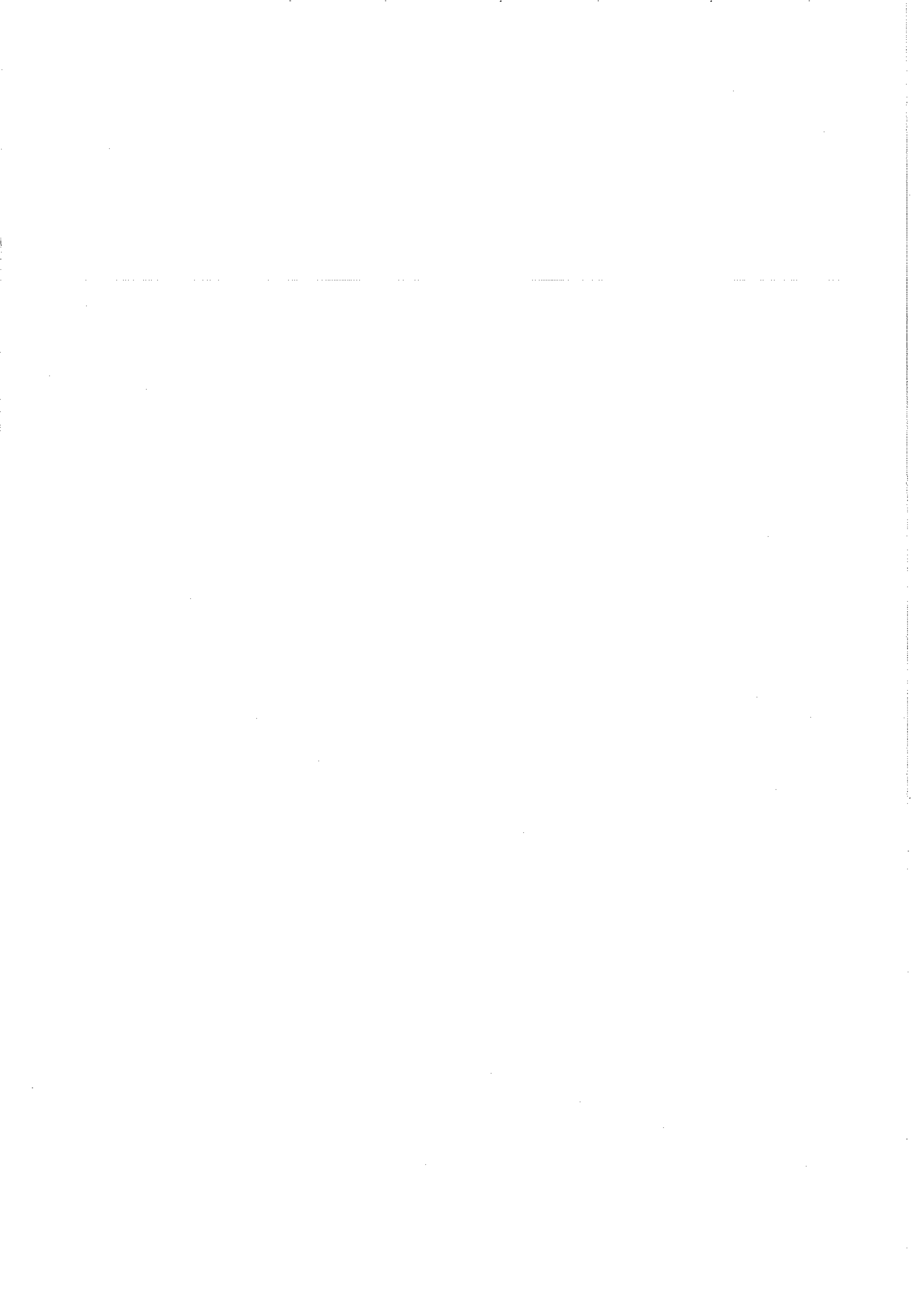
Because of an incomplete policy reform programme, New Zealand has experienced social and economic dislocation on an unprecedented scale. The tragedy is that much of this was avoidable.

While the causes of low economic growth, high unemployment and subdued investment activity are various, we have concentrated in this report on two broad areas – the labour market and social welfare system – which are of fundamental importance, and which have serious implications for the fiscal position since they are the origins of the dominant and fastest growing components of government expenditure.

The substantial reduction in the government's financial deficit since 1985 was primarily due to increases in taxes and government charges. However, even with this greatly increased tax burden, on current policies the medium-term projections in the 1989 budget indicate that the financial balance will deteriorate through to 1992 (see the Appendix).

Much remains to be done if New Zealand is to break free of the cycle of low growth, rising expenditures and taxes, and increasing debt burdens. While the government appears committed to achieving financial balance in the 1990-91 year, unless measures to curtail expenditure are pursued more energetically, New Zealand looks set to see the tax burden move even higher.

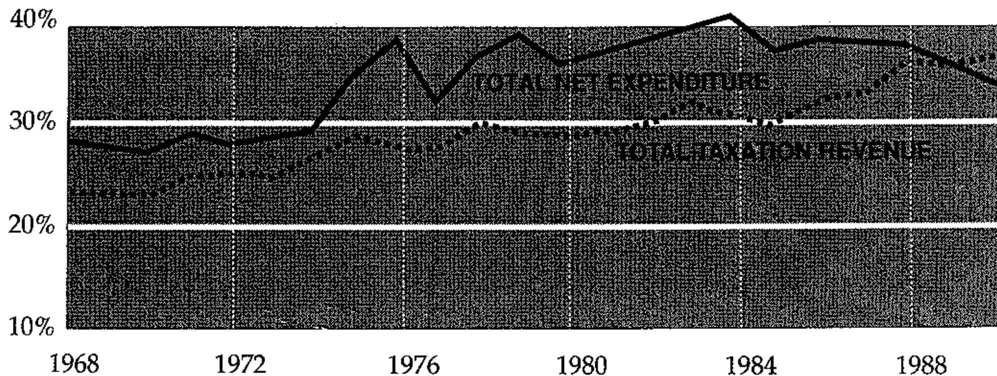
By its reluctance to complete the job of policy reform in New Zealand, the government has undermined the achievement of the very goals that it has set for the country in the 1990s. What is needed in the period ahead is a renewed commitment to pursuing national interests rather than sectional interests and a bold programme of measures which would make such goals a reality.



Appendix: Fiscal Trends

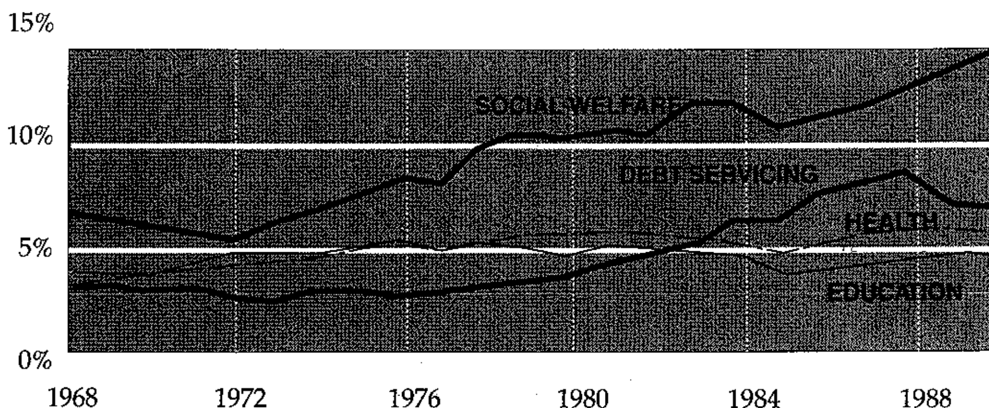
Through the 1960s, government expenditure averaged 27.1% of GDP, and the budget deficit 2.9% of GDP. In common with many other countries, New Zealand initially reacted to the 1973-74 oil shock by expansionary fiscal policies. Government expenditure lifted dramatically to about 38% of GDP in the 1975-76 year (see chart 1), and the budget deficit rose from a low of 1.1% in 1970-71 to 8.6% of GDP in 1975-76 (see chart 3).

Chart 1: Government Expenditure and Taxation (as a % of GDP)



During the next eight years periodic, but ultimately inadequate, attempts were made to rectify the situation. Government expenditure expanded to about 40% of GDP and the budget deficit to a high of over 9% of GDP in the 1983-84 year (although even this figure was understated because of major project and producer board debts, and other contingent liabilities).

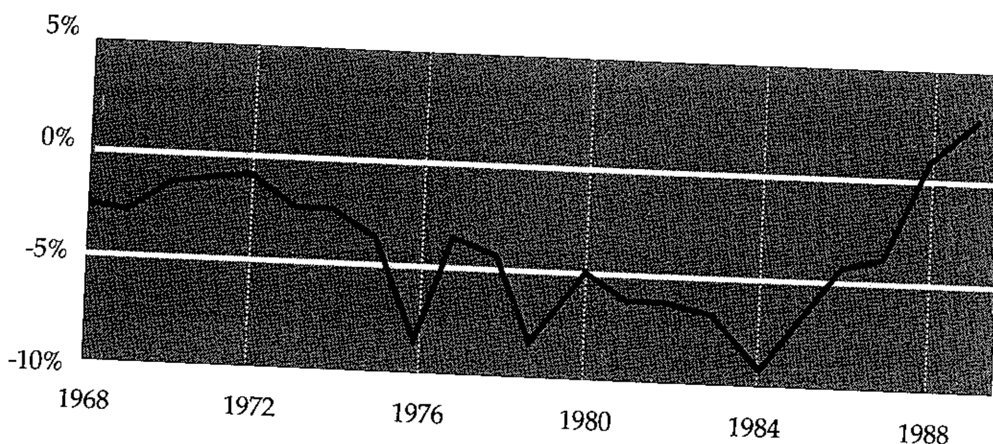
Chart 2: Components of Government Expenditure (as a % of GDP)



The rising expenditure trend was primarily due to the growth of social welfare spending (from the early 1970s), and the growth in debt servicing (from the mid-1970s), as illustrated in chart 2. The growth in debt servicing expenditures, of course, was the result of continuing budget deficits, and the associated legacy of public debt. A further significant element of expenditure growth was due to financial intermediation on the part of the government (e.g. lending to the housing and rural banking corporations), which ranged between 1.5 and 2.5% of GDP from 1975 to 1982. The refinancing by these corporations on the private

market in the past two years, and their loan repayments to the government, is recorded as a negative expenditure in the budget table 2 framework, and contributes to the decline in net expenditure in recent years, shown in chart 1. A consequence of these cumulative public sector deficits (plus major project and producer board losses not recorded in these deficits) was a sustained increase in government debt. Total gross public debt expanded from around 40-45% of GDP in the mid-1970s to reach about 64% of GDP by 1984 (see chart 4). An overall surplus in each of the past two years (due to debt repayments from state-owned enterprises and asset sales) has seen gross public debt decline substantially (with SOE debt showing a largely offsetting rise).

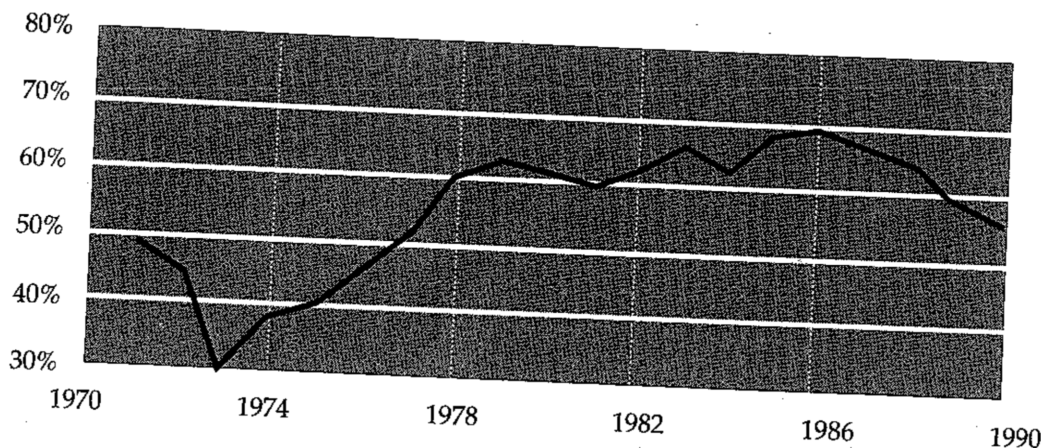
Chart 3: Budget (table No. 2) Balance
(as a % of GDP)



While the fiscal trends through the 1960s and 1970s are clear, the evolution of fiscal policy since 1984 is more difficult to interpret. At the most superficial level, the overall fiscal balance has improved from a deficit of over 8% of GDP in the 1984-85 year to a projected surplus of over 4% in the 1989-90 year. Underlying net expenditure (as recorded in the traditional budget table 2) has been declining as a percentage of GDP (see chart 1).

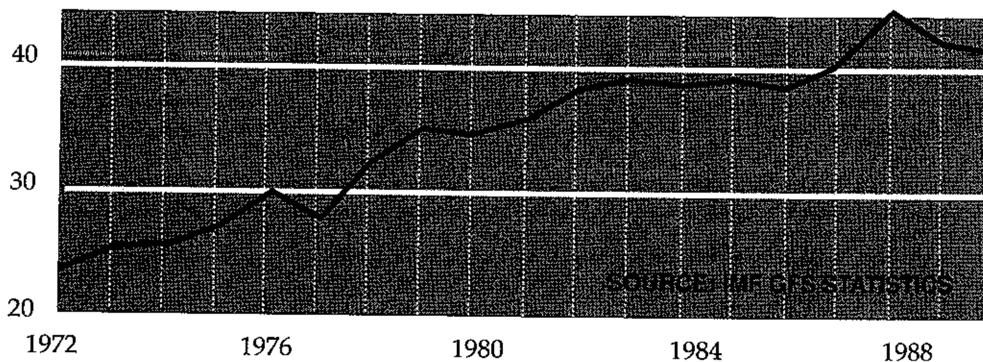
But as is now widely understood, the traditional budget tables are inadequate as a basis for assessing the fiscal position, especially given the changes in financing of expenditure (the asset sales and debt repayments by state owned-enterprises) and the restructuring of the public sector (corporatisation).

Chart 4: Total Public Debt
(as a % of GDP)



For these reasons the government has, to its credit, shifted the focus to the IMF government finance statistics. On this basis, it can be seen that current expenditure (which includes transfer payments, but excludes asset sale and SOE debt repayment proceeds) has risen since 1972 from around 25% of GDP to well over 40% (see chart 5). Government capital spending has been relatively stable, as a percentage of GDP, during this period.

Chart 5: Current Expenditure as % GDP



Even so, further features of the current environment cloud the view of government expenditure trends. These include the introduction of GST, which increased the dollar cost of some government expenditures but was offset by increased revenue, and so did not affect the deficit, and the restructuring of the public sector, which is changing the composition of activities categorised as government and is also imposing a range of one-off transitional costs.

Fortunately the budget annexes provide details of expenditure trends which allow for these influences. Table 1 reproduces material from the 1989 Budget. It shows that, on an *unadjusted financial deficit* basis, net expenditure is expected to increase from 37.4% of GDP in 1984-85 to a (budget night) forecast of 42.3% in 1989-90.

Adjusting these figures to remove expenditures on the reorganisation of the public sector, debt servicing, and unemployment, and to allow for a range of other changes, shows expenditure rising by 2.4% of GDP during this period. However, the costs of both debt servicing and, given the government's resistance to labour market reform, unemployment are likely to be prolonged rather than transitory features of the fiscal problem. Adding these back gives the bottom line of table 1 which shows that, after adjustments, government expenditure has risen from 35.9% of GDP in 1984-85 to a budget forecast of 40.3% for 1989-90, an increase of 4.4% of GDP in only four years. This rise is primarily due to debt servicing and welfare spending (as chart 2 illustrates), although health and education spending have also risen strongly in real terms since 1985.

In the health and education areas it is probably fair to say that the major public concern is the quality of the outputs – the lack of value for money. Few could contend that the 40% real increase in education spending since 1984 has brought commensurate improvements and the recent reforms have been seriously undermined in their implementation. The failure to implement the Hospitals Task Force report in the face of substantial evidence of waste in the management of health resources is a lost opportunity of enormous consequence. The current attempts to address the management problems in the health area, in so far as they cling to bureaucratic/political structures in preference to injecting market disciplines and incentives into the health system, are flawed and will inevitably fail.

Table 1: Trends in Government Net Expenditure

	1985	1986	1987	1988	1989	1990
	$m	**$m**	**$m**	**$m**	**$m**	**$m**
Net Expenditure (Tble 2)	15,318	17,672	24,303	24,175	25,461	26,548
Less:						
Major Project Financing	0	0	3,358	1,058	1,720	1,413
Net Lending	784	685	122	-1789	-2,686	-3,828
Net Expenditure (Net Financial Deficit basis)	14,534	16,987	20,823	24,906	26,427	28,963
—as a % GDP (unadjusted figures)	**37.4%**	**37.9%**	**39.2%**	**42.0%**	**41.9%**	**42.3%**
Less Adjustments:						
Reorganisation of the public sector	600	350	625	725	425	250
Debt servicing	2,563	3,340	4,092	4,971	4,493	4,720
Unemployment benefits	275	291	460	673	987	1,274
Other*	0	11	609	1,633	2,023	2,630
Net Expenditure (after adj.)	11,096	12,996	15,037	16,904	18,499	20,088
—as a % of adjusted GDP	**28.6%**	**29.0%**	**29.1%**	**29.8%**	**30.6%**	**31.0%**
Net Expenditure (including debt servicing and unemployment benefits)	13,934	16,626	19,589	22,548	23,979	26,082
—as a % of adjusted GDP	*35.9%*	*37.1%*	*37.9%*	*39.7%*	*39.7%*	*40.3%*

* Includes influences on expenditure from changes in accounting treatment such as the taxation of benefits, and of GST, fringe benefit tax and employer superannuation subsidy payments.

Source: 1989 Budget, Economic Strategy, p 65.

In spite of these adverse expenditure trends, the financial deficit, the best measure of the fiscal deficit in the current circumstances, has declined from a peak of almost 7% in the 1983-84 year to a forecast deficit of 1.1% of GDP in 1989-90.

Given that government spending has continued to rise, it is no surprise that the dominant contribution to the reduction in the financial deficit was an even more rapid rise in revenue.

Taxation revenue has increased from 29.5% of GDP in 1984-85 to a budget forecast of 36.9% in 1989-90 (although some of this increase is due to GST and fringe benefit tax paid by government departments, and to the taxation of benefits). While the public perception of taxation trends may be dominated by the changes in marginal tax rates, which have generally been reduced, average tax rates have increased steeply.

Table 2 reproduces budget material giving alternative measures of fiscal balance, by respectively adjusting for cyclical and inflation factors. It indicates that, adjusting for the state of the economy, the financial balance is approximately nil, and adjusting for inflation the financial balance is substantially in surplus. While this is encouraging – and implies that debt/GDP ratios will continue to decline - the inflation adjustment will rapidly decline in the next two years as, and if, the government achieves its inflation objectives.

Table 2: Measures of Fiscal Balance – % of GDP

March years	1985	1986	1987	1988	1989	1990
Financial balance	-6.3	-3.1	-3.5	-1.9	-2.1	-1.1
Cyclically-adjusted financial balance	-7.0	-4.4	-4.5	-2.0	-1.2	0
Cyclically and inflation-adjusted financial balance	-4.6	-2.4	-1.0	0.4	0.7	2.5

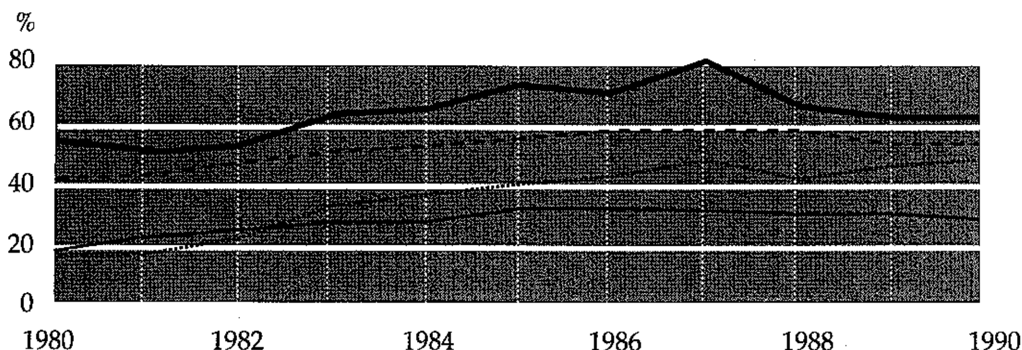
Source: 1989 Budget.

Of more concern are the fiscal projections out to 1992 which, on current policies, show the financial deficit deteriorating from 1.1% of GDP to 1.6% in the 1991-92 year. Note that this occurs in the context of a forecast rate of economic growth of 2.8% in 1990-91, which suggests that the cyclical adjustment would be negligible. With the budget projections incorporating inflation below 2% by 1992, the inflation adjustment will also be small. Thus current policies suggest a cyclically and inflation-adjusted financial balance moving back into deficit by 1992.

If so, New Zealand's still chronic debt ratios would start to deteriorate again. Our past record has left us with debt levels that greatly exceed the average levels for OECD countries (see chart 6).

Because New Zealand is a heavily indebted country, we have limited options. If we are to avoid a significant loss of confidence, internationally, in the programme of economic reform and fiscal adjustment, New Zealand must sustain a genuine fiscal surplus.

Chart 6: Public Debt/GDP Ratios



Source: OECD Economic Outlook, Dec. 1988 & NZ Planning Council