

**New Zealand Young Nationals  
1992 Policy Conference**

**The Next 5 Years - What Now?**

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## **THE NEXT 5 YEARS - WHAT NOW?**

In the short time I have available I want to make four main points.

### **1 The relevant issue is where we go next**

Much can be learned from New Zealand's experience over the last 8 years, and even more from its poor performance over the last 50, but the debate needs to be forward-looking.

Quite plainly, New Zealand has not managed to implement a textbook programme of economic reform.

- The course of monetary policy was erratic, more often too loose rather than too tight, so inflation was slow to fall.
- Fiscal policy was never tight enough. This fuelled asset price inflation up to 1987 and meant monetary policy and internationally competing industries carried too much of the adjustment burden.
- Government spending and the tax burden kept on growing.
- The labour reforms came far too late.
- Assistance to import substitution industries was reduced more slowly than assistance to exporters, thus raising the real exchange rate faced by exporters. This was the concern of Anne Krueger of the World Bank in 1984 when recommending faster cuts in tariffs.
- Until recently, the logic of the reforms was not applied to areas such as health, housing and education, and welfare policies encouraged increasing dependency.
- Political uncertainty and drift undermined business confidence.

But textbook economic transitions are not usually to be found in a world of politics, interest groups and public confusion over what needs to be done. By more realistic standards, New Zealanders can take pride in what has been achieved in a few short years.

In that time we have laid the foundations for a productive, internationally-oriented economy. We have avoided the massive falls in output - often 30 percent or more - that the ex-Soviet Union and Eastern Europe are experiencing. Unemployment will peak well short of the 18-20 percent rates which countries like Spain and Ireland experienced when they were forced to modernise their economies in the 1980s. Over the last 18 months the government has put in place many of the outstanding building blocks needed for success. Although the next year will remain difficult, we are seeing the beginning of a genuine recovery. We should now be concentrating on how to reinforce and sustain it.

## **2 The government's policies now have credibility**

This is evident in the improvements in business and consumer confidence, and in surveys showing more New Zealanders think the country is on the right track. The thrust of the policies is now much more in line with that of more successful countries, and with approaches recommended by organisations like the OECD and the World Bank. It is not, as some looney tunes still suggest, some "extreme", "monetarist", "New Right" experiment.

Events have made it clear that many of the criticisms of recent policies lack credibility. I take Len Bayliss as an example of such critics only because he is taking part in this forum and his views are representative of several others. Over the past 6 years he has:

- Advocated central bank manipulation of exchange rates. Actions by central banks in the 1980s to fool around with exchange rates were major factors in the 1987 sharemarket crash and the current mess in the Japanese equity and property markets.<sup>1</sup>
- Called regularly for a large foreign exchange devaluation.<sup>2</sup> The government's rejection of this option in favour of a better inflation performance than our trading partners, a fiscal tightening which has taken pressure off monetary policy and the currency, and productivity gains from the labour reforms have produced a real exchange rate about 10 percent below its long-run average compared with a high of about 15 percent above average in 1988.
- Argued for centralised wage fixing and opposed the Employment Contracts Act.<sup>3</sup> Some people in business who saw Australian-style incomes policies as a route to competitiveness have been astounded by the productivity gains flowing from the new labour arrangements. Under the Accord in Australia productivity has stagnated. Outside trade union diehards and academics there is no constituency for going back to a centralised and politicised system.
- Attacked plans to cut government spending and deficits.<sup>4</sup> The concern here arises from a view that such action reduces demand and contracts the economy. But New Zealand's problem has not been a shortage of demand. Nominal expenditure on GDP in the 10 years to 1990 grew by 252 percent. Real output on the other hand grew by only 17.4 percent. Our problem has been a shortage of supply. The government's action to put its fiscal house in order last year has been an important factor in the recovery, contrary to advice from academic economists that it would worsen the recession.
- Opposed privatisation: "there would be no gains from the government's privatisation policy."<sup>5</sup> There is now worldwide acceptance of the benefits of privatisation. The privatisation of businesses such as Air New Zealand, Petrocorp, the Rural Bank and Telecom has locked in the gains from corporatisation and improved their performance still further. The government's lack of progress with its privatisation agenda is a puzzle.
- Predicted an "impending downgrading of our credit rating" in mid-1991 and only 6 months ago a balance of payments deficit of \$4 billion for the year

ended March 1992.<sup>6</sup> According to the NZIER this now looks like coming in at around \$750 million. Such predictions gain headlines but do not help the longer term credibility of those responsible for them.

Of course credibility is relative, and the government lost some last year over its budget projections. But its critics are in worse shape. This time last year Terry Hall was lamenting in *The Dominion* that:

"The present government and its advisers have set their hearts against the time-honoured solutions of increasing import protection, monetary controls, state-funded work creation and public works schemes, and higher state spending to stimulate demand."

He has returned to business reporting and is doing a better job in that field. It would be nice to think that other economic commentary might get back on to a sensible track.

### **3 Snake oil is always in plentiful supply**

Despite the proven effectiveness of the policy direction which the government is pursuing, there will always be some who believe it can be improved by quicker fixes rather than by having patience and making efforts to consolidate and extend it.

Right through last year there were calls to 'kick start' the economy, usually by fiscal or monetary expedients. The government sensibly took the view that getting the basics right was the best kick start.

Yet calls for things such as selective tax incentives, government-backed venture capital schemes and enterprise agencies have a habit of coming back, despite New Zealand's long and distinguished history of policy failures with such projects.

Each such proposal needs to be subjected to some basic economic analysis. For example, tax breaks for some businesses (for given levels of spending and borrowing) inescapably imply higher taxes for others. Resources are switched from investments that would be made at undistorted rates of return into activities that become profitable merely because of the tax subsidy. How robbing Dick and Harry to help Tom in this way benefits the economy defies comprehension.

The minister of finance has properly rejected the idea of extending bribes to foreign investors. A sound and stable general economic and political environment is by far the most attractive investment lure. In the taxation area, attention would be better directed to reducing the penalties on equity investment by non-residents and on New Zealand companies that need overseas equity.

Others fret over New Zealand's savings and investment performance, despite the clear evidence that it compares favourably with other OECD countries and that the problem has not been aggregate levels of savings and investment but the poor use to which funds have been put.

There has been a marked improvement in the environment for savings in recent years with moves to low inflation, positive real after-tax interest rates, the switch in

the tax mix from income to consumption and social policy changes which put greater emphasis on private provision e.g. for retirement income.

The common feature of proposals to influence savings behaviour further by regulation or by bribing people with their own money is a belief that people cannot be trusted to make their own consumption and savings decisions and need to be told how to run their lives. Moreover, there is no clear evidence that such schemes can be successful in raising aggregate savings.

The one policy known to work in raising overall national savings is reducing public sector dissavings, i.e. cutting budget deficits. Ironically, many of those who worry about savings performance are the same people who oppose efforts to reduce fiscal deficits because of their supposed 'contractionary' effects.

My view is that savings and investment decisions can largely be left to look after themselves in an environment of low inflation and sound fiscal policy, and that the quality of decisions would be improved further by ongoing efforts to lower the tax burden and reform welfare arrangements. Investment recovered strongly in the OECD countries in the 1980s following programmes of disinflation and structural reform, and a similar recovery can be expected in New Zealand as profitability improves and surplus capacity is taken up.

No doubt other calls, ranging from the well-intentioned to the self-interested, will continue to be heard for government action to 'boost the economy'. New Zealand has never been the land of the invisible hand; typically the economic hand has been very visibly outstretched. Pleas for accelerated depreciation allowances, tax concessions for R & D and employment subsidies replace demands for import controls and tariffs with bewildering speed. By and large the right response by the minister of finance is to say no. More work on things like local government efficiency, privatisation, education performance and reducing the costs of business regulation is the superior answer.

#### **4 New Zealand is far from out of the woods**

We travelled a long way down the road of protectionism and state dependency, and we have only just started on the long journey back. "My child has head lice and I want to know what the government is going to do about it" is an attitude that has long endured.

We still have a high level of industry protection by OECD standards, a lack of competition in the delivery of many social services (e.g. tertiary education and accident insurance), many businesses still in state ownership, barriers to entry into major agricultural processing and marketing activities, and of course a mountainous debt burden which is still growing rather than reducing. Recent policy changes should lift our performance relative to the OECD average, but we are far from having all the ingredients for top class performance in place.

Recently our organisation put out a study arguing for continued efforts by the government to reduce public spending, deficits and debt. An editorial in *The Dominion* took the view that the policies were right but the timing was wrong, and one in the *Evening Post* effectively said that we were probably right but it all sounded a bit hard.

Our response is that a hankering for the warm bath and a habit of postponing hard decisions until tomorrow (and of course never taking them) is the root cause of the economic difficulties and social hardship which the country has been going through. To recommend more of the same is irresponsible. On current projections the government is borrowing another \$7 billion in its present term, or more than \$2,000 for every New Zealander. Plainly this cannot go on. The only argument is about the necessary remedies.

Over the past 20 years, many New Zealand governments have started out boldly and made tough decisions. The Muldoon government, for example, cut the overall fiscal deficit from 10.2 percent of GDP to 4.4 percent in its first year in office, a far larger cut than achieved in the past year. The persistent tendency, however, has been for such action to be followed by backsliding and drift, resulting in an ever-worsening economic position. Good economic management requires tight policies year in and year out. It is much too soon to conclude that we have broken the mould.

I conclude that over the next 5 years fiscal policy will be the determining factor in whether New Zealand builds on its latest effort to claw its way back from the economic brink or loses its grip once again. As the London magazine *The Economist* observed of the recent British election campaign:

"[N]o senior political figure has had the stomach to control public spending, or even to explain why it is necessary. Instead, Mr Major and his ministers have spent the past 15 months showering money on the voters, while Labour has chanted "mean, mean". That has been the central failing of this campaign, and it is why Britain is again threatened with a slide into the third league."

The evidence from the United Kingdom election suggests nevertheless that even relative fiscal responsibility is a political winner and that a perception that a party is committed to a path of high spending and high taxing is a political loser.

I understand that your conference is looking at the idea of abolishing the income tax in favour of levying taxation solely on consumption. That is a worthy vision, but it is a pipe-dream so long as government spending is anywhere near its present level of over 40 percent of GDP and always tending to rise.

Our fiscal report suggested that with disciplined policies and growth in the economy it would be perfectly feasible to get government spending down to around 25-30 percent of GDP by the year 2000. That is the level it was at prior to the 1970s and roughly the present level in Switzerland, Japan and the fast-growing Asian countries. At that point the goal of substantially reducing if not eliminating income tax begins to look feasible. It is certainly a goal worth striving for.

## ENDNOTES

- 1 "Interest and the Dollar: Time for Corrective Action", *National Business Review*, 11 April 1986.  
  
Address to New Zealand Timber Industry Federation, Wairakei, 19 October 1987.
- 2 "Large Devaluation Needed?", *Straight Furrow*, 27 February 1991.  
  
"Large Devaluation Needed Says Bayliss", *The Dominion*, 19 June 1991.
- 3 "Fiddling whilst New Zealand Burns!", Integrated Economic Services New Zealand Newsletter, May 1991.
- 4 "Budget Debt Attack Plan 'Absurd' says Bayliss", *Evening Post*, 1 March 1989.
- 5 "Budget Debt Attack Plan 'Absurd' says Bayliss", *Evening Post*, 1 March 1989.
- 6 "Fiddling Whilst New Zealand Burns!", Integrated Economic Services New Zealand Newsletter, May 1991.  
  
"Bayliss Tips Deficit to Climb to \$4 Billion", *The Dominion*, 17 October 1991.