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Did Someone Say 'Whose Recovery'?

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DID SOMEONE SAY 'WHOSE RECOVERY'?

Few can deny that New Zealand has undergone a remarkable transformation over the last dozen years. By the early 1980s our economy had come to be regarded - both here and abroad - as little short of an international cot case. We were the worst performer in the OECD area on almost any economic indicator. So poor was our growth performance, and so rapidly were our debts mounting, that unless we changed our economic direction we seemed headed for the ignominy of an International Monetary Fund reconstruction package.

That did not happen. We took charge of our own destiny and put in place the market-based reforms that have made such a difference to our country's prospects. Today the evidence of the success of those reforms is all around us. New Zealand will soon be into its sixth year of continuous economic expansion. This expansion shows every sign of continuing: all forecasters are expecting further growth over the next two years. Those critics who complained the recovery would not create many new jobs have been refuted by events. Almost 200,000 new jobs have been created over the last four and a half years - one of the fastest rates of job growth in the OECD.

Other economic fundamentals are unrecognisable from former times. Not long ago the government seemed incapable of running anything other than a string of large budget deficits. More responsible fiscal management and a surge of tax receipts from the expanding private sector has transformed those deficits into surpluses. We are now repaying debt. Not long ago, a 'good' year for inflation was one in which the annual rate was under 10 percent. Today we worry when inflation rises slightly above its 0-2 percent target range, and rightly demand to be assured by Dr Brash that the Reserve Bank is implementing policies to keep it within that range.

The image of New Zealand abroad has also undergone remarkable change. In former times, if foreigners ever thought about New Zealand at all, it was as a place with eccentric economic policies and no future. Today, not only is there huge respect for our economic turnaround, there is also genuine interest in many of the individual reforms which made it possible. Our monetary, fiscal, tax and labour market frameworks are seen as among the best in the world. Rating agencies have been upgrading New Zealand after the downgrades of the 1980s, and we recently had the satisfaction of moving to a higher credit rating than Australia.

Given the virulent criticism directed at the reforms in their early stages, these trends have been of considerable satisfaction to those of us who were strong advocates of economic liberalisation from the beginning. It is salutary to remember that, even in the business community, many argued that the reforms were wrongheaded, and that New Zealand was set on a course for disaster. Given the nature of human pride, we have not been overwhelmed with public recantations by former opponents of the reforms. But there is now a fact which has its own eloquence - the near unanimity in the business community today over the merits of the new policy regime. There is no better example than the change in attitude in the Manufacturers Federation - once one of the bitterest critics of economic liberalisation. Today, under the leadership of Colin Martin and Simon Arnold, it has become one of the strongest supporters of the open and deregulated economy.

The debate over our economic direction has not, of course, gone away. The reforms still have their opponents - not usually in the productive sectors but in political parties, the universities, some church and welfare lobbies, and the media. But the new dynamism in our economy has, of necessity, required most of these critics to make a tactical shift in their line of attack. Instead of claiming as they did that the reforms would not work, or that the recovery would not last, or that it would be jobless, most opponents - usually the same people - will now grudgingly admit that we do have some very good economic indicators. Their new line of attack is to argue that the benefits of the recovery have not been felt by the great mass of New Zealanders.

According to one economically illiterate notion of how living standards rise, it is claimed that the benefits have failed to 'trickle down' from the so-called privileged few. Instead, in some Marxist class sense, 'the rich' are said have become richer while 'the poor' have grown poorer. Sometimes it is argued that lower skilled workers, as a group, are seeing no improvement in their living standards. Yet none of these claims can any longer be sustained. A careful examination of the statistics covering the period since the beginning of the upturn shows that the benefits of the recovery are becoming widely spread among New Zealanders.

We now have gross domestic product data for the four-and-a-half year period between June 1991 - the bottom of the economic trough - and December 1995. In aggregate terms, total real output for the year ended December 1995 was nearly 17 percent higher than in the year ended June 1991. This growth already far exceeds the total growth in the economy over the whole nine years of the Muldoon administration.

Statistics New Zealand provides three different breakdowns of gross domestic product - production, income and expenditure (see Annex). Each category tells an interesting story.

The *production* data show that the expansion has been driven in large part by growth in manufacturing - the sector which, according to some, would be doomed by the removal of protection. Real manufacturing output was 21.5 percent higher in the year to December 1995 than in the year to June 1991. Other sectors to expand strongly since the beginning of the recovery have been construction, up 23.6 percent, trade, restaurants and hotels, also up 23.6 percent, and transport, communications, business and personal services, up 23.5 percent. The clear picture is of a broad-based pick-up among manufacturing and a range of service industries.

The only market sector not contributing significantly to the expansion has been agriculture: it grew by a mere 0.2 percent over the four-and-a-half year period, and its share of total output fell from 8.4 percent to 7.2 percent. These trends suggest that although some parts of it, such as dairying and deer farming, are doing better than others, and value is being added beyond the farm gate, agriculture is becoming a lagging sector of the New Zealand economy. On current projections, manufacturing will very soon overtake agriculture as an export earner. In the Business Roundtable's view, the relatively weak performance of agriculture is due in part to the fact that economic liberalisation has not been as far-reaching in that sector as in most other parts of the economy. In particular, the producer boards still enjoy substantial monopoly or regulatory powers, which continue to hamper new investment, innovation and growth in agriculture.

The breakdown of GDP by *income* group is available only on a March year basis. However, we can obtain a broadly indicative picture of the movement in income shares since the beginning of the recovery by comparing the March 1991 and March 1996 years. We find that compensation of employees grew in dollar terms by 17.9 percent over that period. Most of this growth is accounted for by strong employment growth: 140,000 full-time jobs and 48,000 part-time jobs have been added to the economy since June 1991.

Over that same period there was a 36 percent increase in operating surplus - the measure that comprises income from profits, rent and interest. Some have criticised this increase, since it is substantially higher than the increase in compensation of employees. Such criticism is misconceived. A good proportion of the increase in operating surplus will have already flowed through to low- and middle-income households in the form of interest, dividends, rent and income from small businesses. Moreover, there is no reason to suppose that the ratio of profits to wage income in 1991, or any other past year, was necessarily the 'right' one. Profits in 1991 were abnormally low, and operating surplus is more variable than compensation of employees. In recent years the wage share of income has been much the same as it was for most of the 1960s.

But even setting those facts aside, the increase in operating surplus will alarm only those of the 'let's all stay poor together' school. The improvements in company profitability and in the state of corporate balance sheets are among the most important indicators of the sustainability of the recovery. It is out of operating surplus that most new investment is financed, and it is new investment which leads to tomorrow's jobs. As a country, we can finance new investment out of our own savings, or we can effectively borrow other people's savings by running a balance of payments deficit. The big increase in operating surplus - along with the overdue end to the government's own dis-saving in the form of budget deficits - has enabled an investment-led recovery to take place without placing intolerable pressure on our balance of payments position.

This picture of an investment-led recovery is confirmed by the *expenditure* breakdown of GDP. Between the June year 1991 and the December year 1995, investment rose in dollar terms by a very healthy 41.8 percent, and its share of GDP rose from 17.9 percent to 21.0 percent. Exports rose by 33.2 percent, and both exports and imports increased substantially as a share of GDP. The internationalisation of our economy has clearly been proceeding apace since the recovery began. The big increase in investment, however, has not been achieved at the expense of a rise in consumption. In the final analysis, each of us is a member of a household, and a consumer of goods and services. We find private consumption rose over that same period by 17.1 percent.

The general picture, then, is of a broad-based economic recovery in which almost all market sectors of the economy except farming have taken part. And while profits and investment have shown the biggest increases, the rising tide of the recovery has flowed through into household consumption - particularly through the big increase in jobs. Just as importantly, the characteristics of the recovery - which has not been driven by consumption, inflation or deficit spending - suggest that it is sustainable. Further growth can be expected, which in turn will lead to higher household incomes and consumption.

It is true that wage growth has been comparatively modest since the upturn began. It is quite wrong, however, for critics to assert that average real wages have fallen taking the period as a whole. This claim is often made on the basis of movements in Statistics New Zealand's real wage index. Yet the department is the first to concede that the measure of wages and salaries used in compiling this index has severe limitations - particularly in the light of labour market developments since the introduction of the Employment Contracts Act 1991. The index takes no account of allowances, bonuses and similar payments. Nor does it incorporate productivity-based pay and profit-sharing arrangements. All of these forms of remuneration have increased in importance in the much freer labour market environment of the past five years. Although we have little firm data, the increased tendency for many employers to provide substantial bonuses on top of a standard wage appears to be a significant feature of today's labour market.

In addition, the use of the consumers price index by Statistics New Zealand in the calculation of its real wage index has misled many commentators. Using the CPI to deflate a measure of nominal wages is misleading. This is partly because the CPI does not fully capture the effect of improvements in the quality of goods and services, and partly for other technical reasons associated with the compilation of the index. That is why the Reserve Bank, whose statutory objective is the maintenance of price stability, has an inflation target of 0 - 2 percent not, say, -1 to 1 percent. It is the midpoint of that target range - a 1 percent increase in the CPI - that is effectively defined as price stability in terms of the Reserve Bank of New Zealand Act 1989. Consequently, using the CPI to arrive at a real wage index will understate growth in real wages by around 1 percent per year. Adjusting for this bias is enough in itself to turn a claimed 'fall' in real wages of 2.1 percent since December 1992 into an increase.

While average real remuneration may not have fallen, it remains true that unskilled workers in general have not yet experienced tangible rewards from the economic recovery to the same extent as skilled workers. No one would deny that the gap in wage rates between skilled and unskilled workers has probably widened as the increased demand for unskilled labour has tended to be accommodated by increasing employment rather than higher wages. Indeed such a movement was an inevitable part of building a high-wage economy. Prior to 1984, our economy was structured so as to give very little reward to skills, effort or excellence of any kind. Our wage-setting system, our tax system, and our network of protection and privilege all conspired to create an environment in which the financial rewards from a typical activity often bore little or no relationship to its value to society. This may have given us an 'egalitarian' society in one sense of the word. But the cost was slow economic growth and stagnant incomes for almost everyone. No one benefited from an economy run along those lines - least of all unskilled workers, who increasingly ended up on the unemployment register when times got tough. Today's environment offers far more hope to unskilled workers, because in a growing economy the demand for labour of all types inevitably expands and because a more flexible economy provides more durable job protection.

Nor can we assume that low-skilled workers are failing to benefit from the recovery merely because their market incomes to date have been relatively static. The big improvement in the government's fiscal position is highly relevant to all workers' living standards and future prospects. The ongoing fall in public debt is equivalent to a fall in the portion of debt implicitly 'owed' by each New Zealander. Low-skilled workers are also benefiting in more tangible ways. In its last two budgets, the government has increased annual funding on health, education and other areas of social spending - what some politicians like to call the 'social wage' - by around $2 billion in total. This new expenditure has become feasible only as a result of our economic recovery.

Moreover, on 1 July of this year the first stage of the government's cuts to personal income tax will come into effect. When the second stage is implemented in 1997, the government will have returned over $2 billion in total to New Zealand taxpayers. The tax cuts will have a very substantial impact on workers' real incomes. The after-tax income of a single person earning $25,000 will increase by $1092 or 5.6 percent. A household with two children earning $25,000 will see an increase of $3172 per annum - or 14.4 percent - in after-tax income. Many families will be receiving effective wage increases of between 10 and 20 percent. It can hardly be stressed too often that these gains are only possible because of the dramatic improvement to the fiscal position resulting from our much stronger economic performance.

Thus the assertion that low-skilled workers are missing out on the benefits of the recovery is almost as groundless as the claim that workers in general are missing out. As unemployment has fallen, parts of the labour market have progressively tightened and pay rates for scarce skills have moved upwards. Provided the current policy framework remains in place, there is every reason to expect that low-skilled workers will see increases in their market wages over the next few years. The absorption of the pool of unemployed is essentially a transitional phenomenon. As employment falls below its present level of 6 percent to much lower levels, more and more workers will see their wages bid up.

It was no accident that the introduction of the Employment Contracts Act in 1991 coincided with the beginning of the economic recovery. The ECA changed the dynamics of the labour market in a way that made it much easier for unemployed workers to gain a foothold on the job ladder. It was entirely appropriate that the first major beneficiaries of the recovery should be those who had been trapped outside the labour market altogether, rather than those who at least held down jobs. The interests of the unemployed were previously disregarded by the Labour government which, for all its virtues, was in thrall to unions that represented the interests of their employed members.

We should not forget either that so-called low-skilled people, or people on low incomes generally, often do not stay in that position for long. There is a great deal of movement both up and down the income scale. Yet far too much of the debate about the distribution of income in New Zealand is couched entirely in static terms. We are repeatedly told that a given percentage of the population falls within some definition of 'poverty', or that some small percentage of New Zealanders earns some large percentage of total income, or vice versa. But even where such statements are valid as far as they go, they ignore a quite crucial aspect - the dynamics of income over time. Those people classified as 'poor' one year will not be the same group as those who are so classified the following year. People have a variable earnings profile over their lifetimes, tertiary students forgo earnings in the expectation of higher post-graduation incomes, beneficiaries move off benefits and into the workforce, low-skilled workers gain skills on the job and thereby higher pay, and all manner of other changes occur.

Conversely the 'rich' are not a static group either: many of them are downwardly mobile, as the saying about going from rags to riches and back again within three generations reminds us.

In the United States it has been calculated that only 15 percent of workers on the minimum wage at a certain point in time are still in minimum wage positions three years later. For the vast majority of workers, a minimum wage job is a rapid stepping stone to a higher paying position. Failure to appreciate these dynamics will lead to a misunderstanding of the real distribution of income. It is now abundantly clear that by far the greatest contributing factor to the widening of the income gap that occurred in the late 1980s was the growth in unemployment, which was due in large part to the rigid labour market. Since employment arrangements have been freed up, that situation has turned around. Paradoxically, policies that have been branded as 'uncaring' have done far more for the less well off than those promoted by their critics on the so-called left of politics; their policies reinforced inequalities in the 1980s and would do so again if they were ever reintroduced.

It is crucial, in other words, that we view income distribution in a life-cycle perspective. In New Zealand there has been very little serious analysis of income distribution along these lines. This is now changing, with a very promising programme of work in train at Victoria University's Institute of Policy Studies. Its forthcoming publications should be read by everyone with a serious interest in the issue.

As the fast growing Asian economies and many earlier examples have shown, a market economy spreads its benefits extremely widely, and ours has been no exception. So long as the current policy regime is maintained, further progress is assured. Lower taxes and action to curb the job-destroying behaviour of the Employment Court would speed up the process. By far the biggest risk for low-income New Zealanders is that of a government reverting to some version of pre-1984 policies. After all the gains we have made as a country, that would be nothing short of a catastrophe.