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Economic Reform:
The New Zealand Experience

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ECONOMIC REFORM: THE NEW ZEALAND EXPERIENCE

I greatly welcome this chance to talk about the New Zealand economic reforms, and to learn about South Africa at first hand. It is a fascinating time to be visiting your country. In New Zealand - as elsewhere in the world - there has been huge interest in political developments in South Africa ever since the moves to end apartheid began. No observer could fail to be impressed by the courage, patience and goodwill shown on all sides during the transition to majority rule. In a world still torn by conflict and civil strife in so many regions, South Africa has been a remarkable example of how political progress can be made through dialogue and negotiation.

Yet South Africa still faces a daunting list of problems, with economic problems very high on that list. I cannot pretend to be an expert on the South African economy, but it does strike me that the economic policy regime bears strong similarities to the regime in New Zealand prior to our own economic reforms. In my own country we sometimes called our former policies 'fortress New Zealand'. In South Africa you appear to have the same pattern of fortress-like levels of import protection and extensive regulation over your domestic economy. If that is so, my own view is that South Africa faces a long path of adjustment if you are to put in place a policy regime that gives all of your peoples the most realistic hope for growth, jobs and higher living standards.

Prior to our economic reforms, New Zealand had the most centrally-controlled economy of all the member countries of the Organisation for Economic Cooperation and Development. Indeed, our entire economy was a network of controls and cross-subsidies, in which almost every sector did its best to live off every other sector. Our regime was exemplified by its very high levels of import protection - achieved through a mixture of tariffs and import licensing. Though we had been slowly lowering protection, our import barriers still remained a formidable fortress at the time we embarked upon our reforms. Our export sector was also heavily subsidised. Exporting manufacturers received tax breaks, while farmers received large cash handouts. Agriculture - which then produced most of our export income - was subject to the monopoly control of agricultural marketing boards. Even today these producer boards - as we term them - still stand, largely unreformed, as a relic of old New Zealand.

Our domestic economy was as heavily regulated as the international sector. We had adopted the British system of industrial relations, and developed an even worse version. Most workplaces were covered by a nationally-negotiated award setting out the wages and conditions applying to that job. There was minimal scope for individual employers and employees to opt out of these centrally-determined arrangements. Workers and management were locked into a system that put them in perpetual conflict with each other. Productivity was greatly compromised and strikes were endemic.

Where the government was not merely regulating it was running its own businesses - and doing it very badly. There was a wide range of government trading activities, from financial institutions to a hotel chain. Many made losses. Almost all were inefficient and gave poor service. The need to 'protect' the 'jobs' in these businesses caused many government activities to be shielded from competition. Financial markets were also tightly regulated, and interest rates were controlled. There were

foreign exchange controls and a fixed exchange rate regime. Our tax system relied too heavily on direct rather than indirect tax, and was full of loopholes. Increasingly high personal and company tax rates were being levied on an inadequate tax base. With government spending out of control, fiscal deficits were routine from the 1970s onwards. Monetary policy could be most kindly described as inconsistent. Inflation was for some years between 10 and 20 percent until the government, tiring of this situation, attempted to abolish price rises by a generalised price freeze.

The cumulative result of these policies was the most inefficient and worst performing economy in the OECD. We had the lowest per capita growth rate of any OECD country - a result of the lowest rate of growth in productivity. We were also adding to our debt at a dangerous rate, and indeed had the fastest build-up of both government and overseas debt of any OECD country. Despite this abject record of economic stagnation and 'borrow and hope' policies, our prime minister of the day had taken to lecturing the rest of the world on how it should reform the international financial system. Fortunately, no one was listening. Ironically, this particular politician's last week in office coincided with a foreign exchange crisis.

1984 was our watershed year. Beginning then, and continuing for another decade, successive New Zealand governments implemented a series of reforms notable for their scope and, for the most part, mutual consistency. It was a remarkable period in our modern history. Though the reforms were highly controversial in their initial stages, and though mistakes were made in their implementation, they succeeded in transforming the economic landscape almost beyond recognition. The old economy of 1984 already seems a lifetime ago.

The leading theme of our reforms was the liberation of market forces - a principle entirely consistent with mainstream economic thinking concerning the value of markets in creating wealth. Our external sector was opened up to international competition and expected to compete without reliance on subsidy and high protection. Domestic industries were similarly exposed to competition. Price controls were lifted. And while markets were expected to be the engine of economic growth, it was recognised that the government's monetary and fiscal policies played a crucial role in providing a stable and supportive framework for the private sector. That meant reducing the fiscal deficit and dedicating monetary policy to the elimination of inflation.

No sector was deregulated more rapidly and more completely than the financial sector. All direct controls on interest rates were removed almost immediately. Individual ratio controls on financial institutions were also scrapped, and monetary policy has since operated by controlling the aggregate quantity of base liquidity held by the banking system. The foreign exchange market was also fully deregulated. After an initial devaluation of the exchange rate to halt the run on the New Zealand dollar, all foreign exchange controls were rapidly phased out. In 1985 our exchange rate was floated. Already by then our central bank, the Reserve Bank of New Zealand, had switched the focus of monetary policy towards the explicit reduction of inflation. The floating of the exchange rate gave the Reserve Bank the final freedom it needed to control the monetary base. Ever since, the Reserve Bank has run a 'clean' float of the New Zealand dollar. Though the exchange rate is always an important indicator for monetary policy, at no stage has the Reserve Bank intervened directly on the foreign exchange market in order to influence its value.

Another early highlight of the New Zealand reform programme was the reforms to our tax system. The welter of tax concessions to various activities had seriously distorted business decisions. The tax reforms were aimed at reducing these distortions, and reducing the large disincentives to work built into our income tax scales. This inevitably meant broadening the tax base. The principal initiative was the introduction of a Goods and Services Tax (GST) in place of the existing multi-rate wholesale sales tax. The GST is a value-added tax, levied at a flat rate on virtually all goods and services (initially 10 percent and now 12.5 percent). At the same time, the top marginal income tax rate was brought down from 66c in the dollar for individuals and 48c for companies to 33c for both individuals and companies, and compensating adjustments were also made to offset the effects of GST on those on low incomes.

The early period of reform also saw the virtual elimination of export subsidies. The rural sector went through a particularly difficult period of adjustment in these years, since it was simultaneously hit by a world downturn in prices for agricultural products. With the fiscal deficit still not under control, and an anti-inflationary monetary policy now being applied, interest rates and the exchange rate were often at very high levels. Import protection was coming down, but on a slower track. While this was a difficult period for both farming and manufacturing exporters, the urban economy was far more buoyant than the rural economy. A boom in commercial property development was taking place, assisted by the deregulation of the financial markets, and a bull run on the sharemarket was underpinning confidence.

By late 1987 the balance of the adjustment pressure was changing. The rural sector was recovering, while the urban economies were beginning to slide into recession. This process received a new impetus with the October 1987 sharemarket crash, which in New Zealand was particularly severe. Average equity values almost halved, leaving many corporates with very weak balance sheets. The sharemarket crash was the end of the line for a number of our high-flying but insubstantial businessmen, whose brief fame soon turned to bankruptcy and often notoriety. For almost all of us, the next three years were a period of often very difficult adjustments. No industry went through a bigger shake-out than commercial property. Domestic industries faced weak demand. Producers of internationally-traded goods were continuing to see reductions in import protection, and many were forced to reorient their businesses towards exporting.

Painful though this period was, it saw some major improvements in productivity as businesses rationalised their operations in order to survive. Already the time was largely past when a business could successfully lean on the government to change the rules of the economic game in its favour. And while the predominant economic mood was gloom, some important indicators were clearly improving. Inflation, for instance, fell steeply in the course of 1988 from the heights it had reached immediately after the break-out from the price freeze. And the diversification of New Zealand's exports continued, taking us slowly away from our traditional narrow base of just a few bulk pastoral products.

While the private sector was undergoing adjustment, a revolution was also occurring in the entire government sector. The New Zealand public sector reforms took place over a number of years, and have placed us at the very forefront of world practice. Previously our government sector had been characterised by high levels of bureaucracy, centralised control, confusion of objectives in government departments,

poor incentives, a virtual absence of accountability, and inefficiency at all levels. In short, it was a typical government sector. The public sector reforms were aimed at clarifying roles, specifying clear objectives, giving public sector managers the power to manage, and introducing much stronger accountability mechanisms. In this process, almost every government department underwent significant restructuring.

A key principle in the public sector reforms was the separation of commercial from regulatory and other functions. The trading activities of government departments were restructured into State-Owned Enterprises (SOEs), whose shares were held by ministers on behalf of the taxpayer. The new SOEs were given clear profit objectives, made to pay tax and dividends to the government, and forced to borrow in the private sector. Their business activities were also opened up to competition from new entrants. People with business acumen were brought in to run the new companies. The day-to-day involvement of cabinet ministers in business decisions came to an end. Since then, the role of ministers has been confined largely to appointing SOE directors and monitoring the performance of boards.

Under these new disciplines, the improvement in commercial performance was immediate and dramatic. Productivity increases of 30-50 percent were common in the new SOEs, while there were also substantial improvements in customer focus and the quality of goods and services. For instance, the new telecommunications SOE almost doubled its productivity as a result of corporatisation. Telecommunications prices fell, while the waiting time for the installation of a new telephone dropped from six weeks to two days. The huge efficiency gains from corporatisation were not only of major benefit to consumers and taxpayers. They represented substantial cost reductions to the private sector.

While the results from the corporatisation programme were spectacular, this had only been achieved by reproducing, as faithfully as possible, a private sector environment in the public sector. But governments do not have an advantage over the private sector in running businesses. Indeed it is the private sector which possesses the superior monitoring mechanisms and incentives. The recognition of this fact led to New Zealand's privatisation programme. Over \$13 billion worth of state assets have so far been sold, the great majority by open tender. The objective of each sale has been to maximise the price received by the taxpayer. Interest by overseas buyers has generally been strong, in part reflecting confidence in the wider liberalisation programme.

Our core public sector underwent a quite different transformation. For the first time, departmental heads were put on to fixed-term contracts and became directly accountable to their ministers for the performance of their departments. They also gained control over all of their major departmental inputs, including the key input of labour. Departmental appropriations shifted from an input to an output basis. Each chief executive now has an annual performance agreement couched explicitly in terms of the departmental outputs to be delivered to the minister. Instead of the old 'black box' public service, where we simply poured money in one end and hoped something would come out the other, ministers can now see which outputs they are 'purchasing' from their department on behalf of the taxpayer. They can switch funding from low priority to high priority outputs, in accordance with the government's wider social objectives, and can have genuine confidence that their departments' activities will reflect ministerial priorities.

Information systems and reporting requirements in the core public sector have increased in sophistication enormously as a result of the reforms. We are the only sovereign country to use accrual accounting for our public sector, and to calculate a balance sheet for the whole of the government. Our budget process is now very transparent. The openness even extends to a legal requirement for the government to publish a full economic and fiscal update just prior to each general election.

Moreover, since the passing of the Fiscal Responsibility Act in 1994 the government is itself legally bound to conduct overall fiscal policy in accordance with specified "principles of responsible fiscal management". One of these principles is to reduce government debt by running budget surpluses until "prudent" levels of debt have been reached. Once debt is down to these levels, the government must run roughly balanced budgets, not necessarily every year, but "on average" and "over a reasonable period of time". Thus the legislation imposes a budget balance requirement on the government as an overall principle of policy, while not forcing it to artificially balance the budget in periods of cyclical downturn. If the budget does get out of balance, the government must explain how it intends to return to the principles of responsible fiscal management. Thus the Fiscal Responsibility Act 1994 forces the government to take a medium-term approach to its fiscal policy. It does so without compromising the government's ability to pursue its social objectives.

A similar desire to ensure a medium-term focus to policy motivated the passing of the Reserve Bank of New Zealand Act which came into effect in 1990. The Reserve Bank of New Zealand Act 1989 is based on the view - which is widely accepted in academic thinking - that the only contribution monetary policy can make to growth and employment in the medium term is to eliminate inflation. The Act also recognises that politicians are often tempted to misuse monetary policy for short-term political ends. Accordingly, the Act sets down "stability in the general level of prices" as the prime objective of the Reserve Bank, and provides our central bank with a high degree of autonomy to carry out that task. Under the Act, the Reserve Bank Governor and the minister of finance must negotiate a policy targets agreement detailing how the Reserve Bank will carry out its primary function. The price stability target in the current policy targets agreement is expressed as annual consumer price inflation of 0-2 percent. This constitutes a narrow target, which will not invariably be met on an annual basis. However, when the target is breached the onus is strongly on the Governor to publicly account for the lapse, and to explain how the Reserve Bank intends to return inflation to within the agreed band.

Thus the Reserve Bank of New Zealand Act 1989 largely removes monetary policy from the day-to-day political control of the government. However, there is provision in the Act for the government of the day to temporarily override the price stability objective by specifying a different objective for the Reserve Bank. Such moves must be undertaken publicly, in full view of the financial markets. Since the markets would immediately punish the government through higher long-term interest rates, it seems unlikely that any government would risk such an attempt in normal circumstances.

The Reserve Bank of New Zealand Act 1989, together with the series of public sector reforms culminating in the Fiscal Responsibility Act 1994, provide New Zealand with an institutional framework unique in the world for macroeconomic policy. While allowing for some short-run flexibility, the framework imposes a very strong medium-

term presumption in favour of price stability and balanced budgets. This has boosted the credibility of government policy, and the two statutes have become of high symbolic importance for foreign investors.

One sector largely ignored until late in the reform programme was the labour market. This neglect was a serious mistake in the sequencing of reforms, and cost New Zealand dearly in lost output and employment. In 1991, however, the anomaly was rectified with the passing of the Employment Contracts Act, which transformed the rules of the labour market. The old national award system was replaced by a regime which, with a few exceptions, allows general freedom to contract. The new Act provides for both individual and collective contracts between employers and employees. Whether an employee is on an individual or collective contract is a matter for negotiation between the parties. Unions still play a significant though reduced role in industrial negotiations, but compulsory membership has been abandoned along with the automatic right of unions to represent workers.

The Employment Contracts Act 1991 has led to a major cultural change in New Zealand workplaces. There is much improved communication between management and workers, and strike activity has fallen markedly. Employers report higher productivity as a result of changes to working hours and greater flexibility in work practices made possible by the Act. The level of staff training has increased. There is more multi-skilling, as the rigid demarcation lines of the old regime have been abandoned. Individual contracts are now common, and those on individual contracts report high levels of job satisfaction.

In 1991 the government also moved to correct the other remaining imbalance of the reform programme - excessive government spending. Significant reductions were made to a wide range of social welfare benefits, while eligibility for benefits was tightened. Other areas of government expenditure were also cut. 1991 turned out to be a pivotal year. We had gone through our biblical seven lean years since the commencement of the reforms in 1984. Now, in the second half of 1991, the economy finally turned up. By then we were seeing extensive benefits from rapidly falling inflation, lower interest rates, a lower exchange rate, the new possibilities under the Employment Contracts Act 1991, and the lower cost structure from deregulation elsewhere in the economy. All of these elements were supporting a sustainable recovery.

In the four-and-half-years since then, annual economic growth has averaged over 4 percent, with no sign that the expansion is coming to an end. Sophisticated manufacturing exports have grown very strongly. The export sector has continued to diversify, both in terms of product and country of destination. Links with the fast-growing East Asian economies have continued to expand: six out of our top 10 export markets are now in Asia. The net flow of people leaving the country has turned around, and New Zealand is now a highly sought after destination for immigrants. Foreign investment flows into the country have grown to substantial levels.

The strength of the recovery, combined with the liberalisation of our labour market, has led to the creation of almost 200,000 new jobs since the upturn began. Unemployment has fallen from a peak of around 11 percent to just over 6 percent today. Inflation continues to be controlled within or close to its 0-2 percent target range. And after almost a generation of continuous fiscal deficits, the government's

own accounts have now swung strongly into surplus. The government is now not only repaying debt. So strong is its fiscal position that it has announced a two-stage programme of major cuts to personal income tax. The strength of the fiscal position and the ongoing success in controlling inflation are two signs that the recovery is sustainable. Moreover, it is becoming increasingly difficult to deny that the benefits of the recovery are being widely felt by ordinary New Zealanders.

There is now wide recognition abroad that the New Zealand economy has turned the corner. The latest World Competitiveness Report, put out by the World Economic Forum and the International Institute for Management Development, ranks New Zealand eighth in the world for overall competitiveness. The Heritage Foundation - an American thinktank - has said that New Zealand has the fourth freest economy in the world. *The Economist* magazine commented last year that our macroeconomic framework is probably the best in the world. Many other commentators have written flatteringly about the quality of our reforms. There is wide interest in our core public sector reforms, where we are regarded as a world leader. Our Goods and Services Tax has been widely studied. And with many countries struggling with high unemployment, there is now considerable interest in the success of our Employment Contracts Act 1991 in creating jobs.

The successful implementation of New Zealand's reform programme did not come about easily. It was due to the determination and far-sightedness of some outstanding politicians, and to the support they received from those in the community who took the long view about what needed to be done to give New Zealand a future. The up-front costs of the reforms were high. There was strong resistance by those unwilling to give up their protection and privileges, by many in the media, and by some of our traditional politicians. But there were also groups which could see that the short-run difficulties we experienced were those of transition, or of unbalanced reform, and which urged the government to keep up the reform momentum. I am particularly proud of the role played by an organisation of which I am a member, the New Zealand Business Roundtable, which comprises the chief executives of most of New Zealand's major companies. It was a consistent supporter of the reforms and an advocate of their extension. Indeed, even today the Business Roundtable is continuing to argue that more should be done to make New Zealand a high-growth, high-wage economy.

Looking back on the New Zealand experience, there are a number of lessons that we can draw. First, it is almost impossible to go too quickly in implementing economic reform. Gradualism is almost always inferior to rapid reform. Under a gradualist approach, the benefits of reform will be delayed, and there is a real risk of never reaching the desired end-point. It is far better to move boldly, demonstrate some gains, and maintain a sense of momentum. In New Zealand we went too slowly. Though our reform programme began quite rapidly, the momentum slowed when the prime minister of the time called for the now infamous 'tea break'. A revitalisation of the reform effort finally saw policy balance largely achieved around seven years after the reforms began. Though for many New Zealanders the pace of change seemed too fast, in reality a more consistent and sustained programme would have reduced the difficulties of transition.

Secondly, reform needs to be comprehensive. Imbalances in the programme can seriously compromise the goals of reform. In New Zealand's case, the failure until late

in the programme to control government spending hurt our export industries. So did the delay in tackling rigidities in the labour market. The sequencing of reforms in an economic liberalisation programme is a much debated issue. I do not believe that we need to worry too much about what the precise sequence should be so long as overall consistency is achieved in a relatively short timeframe. However, the New Zealand experience does underline the fact that labour market reform must come early if transitional costs are to be minimised.

Thirdly, good communication is very important. Enough people must understand where the programme is heading and why reform is being undertaken. The onus to communicate the benefits of reform is not just on politicians, but on all those in the community who believe in the economic direction and want to see it extended. We can expect to see reform fatigue emerge, and re-emerge, both in the business community and among the general public in the course of a reform programme. There will always be a tendency in many quarters to hope that no more reform is needed. In New Zealand this is the predominant mood even today - the feeling that we should be content simply to 'bank' the gains from the reforms so far. This attitude can only be countered by the advocates of reform continuing to point out the need for continuous adaptation to a rapidly changing global economy.

Fourthly, we should not expect the process to be quick or easy. It will take time before the benefits of reform are clearly seen. The faster and more comprehensive the reform, the more that time-lag will be shortened. But it will not be eliminated. A sense of realism about the timetable for the benefits of reform to be felt needs to be communicated to the general public. Only then will the reformers be in the best position to keep the momentum of reform going.

Finally, reform is never ending. There is always more to be done. You will need to be vigilant that politicians and interest groups do not succeed in efforts to undo what has already been achieved. But while patience and determination is certainly needed, the eventual benefits of reform will abundantly compensate for the adjustment costs. That, above all, is the lesson from the New Zealand experience.