New Zealand's Radical Reforms

Paul E. Atkinson

In a little over a decade the New Zealand economy, once characterised by a high degree of interventionism, has been radically transformed. There has been a dramatic improvement in economic performance in recent years. The New Zealand experience offers a rich array of ideas for other countries re-examining their own economic and social arrangements, although the transferability of these ideas will depend on the ability of these countries to adapt them to their own social and political context.[1]

From its early settlement during the nineteenth century, New Zealand had an economy based on natural resources, with lucrative exports – not least pastoral products such as wool, meat and dairy products – sold mainly to the United Kingdom. The high incomes that resulted encouraged further immigration, as well as capital inflows that financed development. As recently as 1960, per capita incomes in New Zealand were surpassed only by those in the United States and Switzerland. But decline had already set in and by the mid-1980s New Zealand was one of the poorest of the advanced countries (Figure 1). With the threat of continued outward migration, indeed, even its status as a developed country could not be taken for granted.

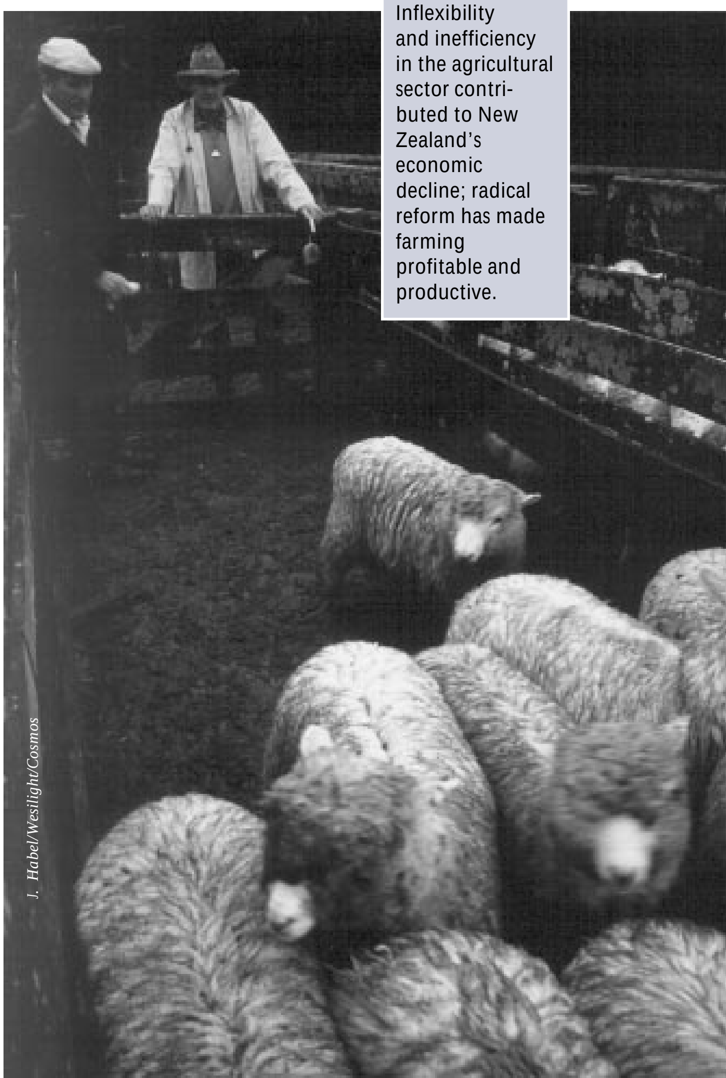
The seeds of this decline were probably sown as early as the 1930s, when world commodity prices collapsed and the international lending which sustained the capital inflows on which the economy depended ceased. The resulting depression changed the intellectual and political climate in New Zealand, ushering in a bigger role for the state in the management of the economy and encouraging efforts to be more self-reliant – even autarchic.

In the years following the Second World War economic management in New Zealand became highly interventionist. There were frequent shifts in budgetary policy to manage aggregate demand. The national currency was open to being, and increasingly indeed was, devalued to sustain demand. A cradle-to-grave welfare system, largely supported by taxation, was developed. There was frequent resort to controls in labour, product and financial markets. Reliance was placed on the state for financial support or for the actual operation of many industrial and commercial activities. And an elaborate system of border protection to encourage a diversified manufacturing base was established.

Paul Atkinson is Head of the Economic Prospects Division in the Policy Studies Branch of the OECD Economics Department.

E-mail: eco.contact@oecd.org

1. ***OECD Economic Surveys: New Zealand***, *OECD Publications, Paris, 1996; Donald T. Brash,* New Zealand's Remarkable Reforms, *Occasional Paper No. 100, Institute of Economic Affairs, London, 1996; Graham C. Scott,* Government Reform in New Zealand, *Occasional Paper 140, International Monetary Fund, Washington DC, October 1996.*



J. Habel/Wesilight/Cosmos

Inflexibility and inefficiency in the agricultural sector contributed to New Zealand's economic decline; radical reform has made farming profitable and productive.

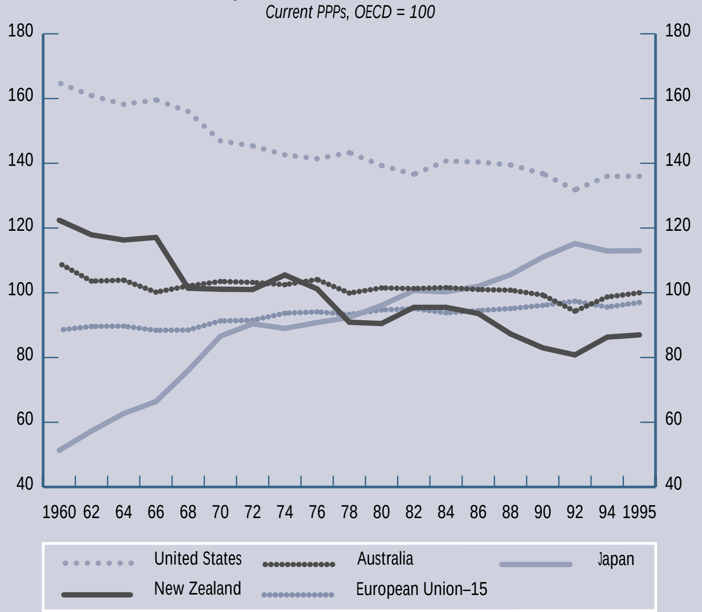
New Zealand's Radical Reforms

Many of these trends were reflected in economic policies in other advanced countries, of course, but mostly they were more pronounced in New Zealand. And the exceptionally high degrees of border protection, which were more typical of the developing world, were almost impervious to the liberalising trend that operated in advanced countries in the northern hemisphere from the 1950s.

Figure 1

GDP Per Capita in Five OECD Countries, 1960–95[1]

Current PPPs, OECD = 100



1. 1995 figures are OECD estimates.

Source: OECD

The sudden rise in oil prices in 1973–74 brought a rude shock nearly everywhere. But in New Zealand the terms of trade collapse that followed was less damaging than the accession of the United Kingdom to the European Community which occurred around the same time. The Common Agricultural Policy increasingly restricted New Zealand's access to what had historically been its core export market. The policy response was to resist adjustment and to reinforce the adverse trends already at work. Budgetary policy became increasingly destabilising, high inflation became entrenched, waste resulting from the political direction of investment decisions became more pervasive, detailed controls in labour and financial markets were reinforced, and the government resorted with growing frequency and volume to international capital markets to finance its budget and current-account deficits.

Intellectually, by the early 1980s, there had been a widespread international rejection of the sort of policies which New Zealand had been following. And most Latin American countries, whose policy approaches had much in common with New Zealand's, had lost access to the international financing on which, again like New Zealand, they had come to depend. Against that background, with the distortions and macro-economic imbalances in New Zealand obvious to anyone who cared to look, and in the midst of a collapse of confidence in the foreign-exchange market, the election in July 1984 brought a new Labour government to power.

The Essentials of Reform

It would not be fair to say that no economic reforms had been undertaken before then. Steps had been taken to liberalise road transport, for example, and the Closer Economic Relationship agreement with Australia was an important first step in opening the country to the international economy. But such changes had been *ad hoc* and incremental. Stimulated and supported by the atmosphere of crisis in which the election had occurred, the new Labour government embarked on a series of sweeping reforms which affected nearly all aspects of the New Zealand economy. The broad thrust of these reforms was not only maintained but reinforced following the transfer of power back to the National Party in 1990, and the recent arrival of a new coalition government appears unlikely to lead to a major reversal.

The process of reform was guided by a number of lines of thought which appeared to provide an alternative to the inward-looking and interventionist framework which had evolved during the previous half-century. Although they could be regarded as conservative, even 'right wing', they were also consistent with a concern about distributional questions and social issues. The Labour government, in particular, saw economic reform at least partly as a means of generating the resources required to improve the social safety net and social services. The National government which succeeded it was prepared to take harder decisions about the costs of the welfare state. Although the scope and design of the welfare state are still the subject of political debate in New Zealand, the outcome of this discussion seems unlikely to affect the bulk of the reforms that have been put in place in other areas.

Few sectors of the economy escaped scrutiny. Two major changes were made almost immediately. First, financial markets were liberalised rapidly, and all controls on interest rates, borrowing and lending activities and foreign-exchange transactions removed. In March 1985, the exchange rate was allowed to float. No public money has been spent on foreign-exchange market intervention to influence the exchange rate since. A light supervisory framework has been put in place which focuses mainly on resolving problems expeditiously once they have occurred; it gives little emphasis to preventitive regulation.

Second, in view of the mounting budget costs, subsidies and other support to agriculture were withdrawn. OECD figures for producer subsidy equivalents show that New Zealand is now virtually alone among developed countries in obliging farmers to adapt fully to global market conditions (Figure 2).

Subsequently, the macro-eonomic policy framework was redefined. The Reserve Bank Act made price stability the goal of monetary policy. The Act did not make the Bank fully 'independent' of the Government, as is often reported, partly since complete independence was not felt to be desirable and partly because there are no constitutional means for doing so. Rather, it transferred responsibility for day-to-day operating decisions from the Minister of Finance to the Governor of the Reserve Bank, and established a contracting framework to ensure accountability. The Fiscal Responsibility Act established principles of responsible fiscal management, and required transparent and detailed explanation by the government of the day about the reasons for any departure from these principles and about how it proposes to return to them.

Government trading and commercial activities have been largely separated from bureaucratic management and control and set up as businesses (corporatised). Many have been privatised. The privatisation programme since 1988 may be the most extensive of any developed country.

Budgeting, management and accounting in the 'core' government (that is, departments and non-commercial agencies) have been reformed to facilitate better management and more accurate assessment of performance. Accounts, which were previously prepared on a simple cash basis, must now conform to generally accepted accounting principles that apply to private businesses. The new accounting system requires both accrual and cash accounting, separate current and capital budgets, and provision of balance-sheet information as well as income and operating statements. Department heads are employed on fixed-term contracts of up to five years, which specify what ministers expect from the department in terms of performance, and the budget allocation with which the department head finances those services. At the same time, the department head is now allowed considerable discretion in managing this budget allocation. In particular, decisions over staff sizes and their pay have been devolved to department heads.

Comprehensive tax reforms have generally broadened the base, flattened rates and integrated business and personal tax systems.

Quantitative restrictions on imports were replaced by tariff equivalents, exposing virtually all product markets to the possibility of competition. Tariffs have since been made more uniform and substantially reduced.

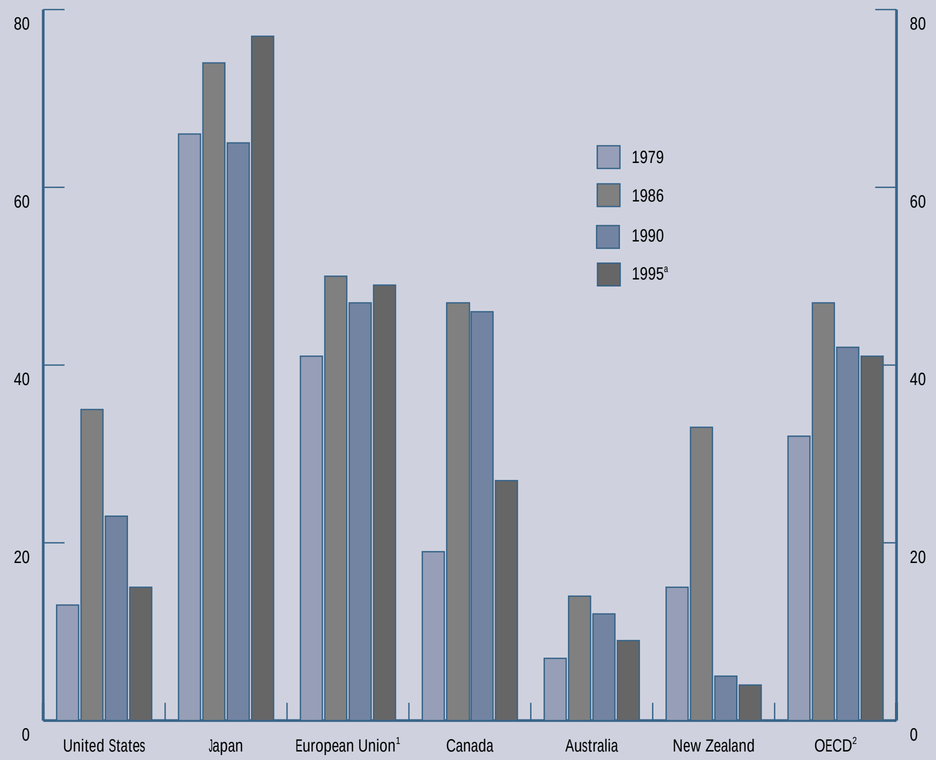
The State Sector Act (1988) and, more importantly, the Employment Contracts Act (1991) have made employment contracts similar to other types of contracts. Employers and employees can choose with whom, and within what structures, they associate. All bargaining is toward an employment contract, which can be either collective or individual. The aim of the legislation has been to encourage decentralised bargaining in enterprises themselves. That would allow pay and work practices in individual companies to adapt themselves to conditions specific to particular industries, regions or an enterprise's own circumstances.

Social policies have been addressed less comprehensively but changes have occurred.

The National Government has made changes to contain the costs of income support, but programmes have not been radically transformed. Spending is about where it was ten years ago (more than 11% of GDP) and the number of beneficiaries continues to rise rapidly.

And housing policy now offers low-income households a supplement in the form of a cash grant or voucher which replaces housing assistance previously delivered in the form of subsi-

Figure 2
Producer Subsidy Equivalents, 1979–95
% of value of agricultural production



a. Provisional.
1. EC-10 for 1979; EC-12 for 1986; includes all of Germany since 1990; EC-15 for 1995.
2. Weighted average.
Source: OECD

dised rent or loans for home-ownership. In health care, a 'contract system' similar to that in the United Kingdom has been created.

The Response to Reform

The effects of the reforms can be examined from two different angles. First, did the reforms, taken individually, succeed in addressing the specific problems at which they were aimed? And, second, taking into account the adjustment costs that were inevitably involved, did performance improve as a whole?

A number of individual reforms scored clear successes. Most importantly, the macro-economic imbalances which were leading the country towards crisis have largely been addressed, and, indeed, New Zealand's international credit-rating has been upgraded twice to just below AAA (the highest available rating) by the main rating agencies. There has been a massive improvement in the budget position: the surplus is now large and appears likely to continue. Net government indebtedness is declining sharply from more than 50% of GDP in 1991 to below 30% now and a projected 20% by 1998. The New Zealand government, ten years ago one of the world largest borrowers in international capital markets, has now eliminated its net foreign-currency debt. The current-account deficit has likewise come down substantially, from nearly 9% of GDP in 1984 to around 4% last year, despite strong growth in recent years and capacity constraints which are often relieved by higher imports. Inflation, too, has come down from the 10–20% range during the 1970s and most of the '80s to around 2%.

Other successes are also apparent in terms of making the economy more efficient and raising living standards. The productivity and financial performance of state trading activities (many now privatised) have generally improved, and in many cases real output prices have fallen. In the coal industry, for example, the workforce was halved while output increased. The port companies formed by the harbour boards cut their workforce by 50%, lowered prices by between 20% and 50%, and reduced turnaround time for ships by as much as 56% at the port of Tauronga. Telecoms Corporation reduced staffing by around two-thirds between 1987 and 1995, and increased productivity by 85%. The waiting time for a telephone has fallen from six weeks to one day. New Zealand Rail Ltd cut freight rates by 50% in real terms between 1983 and 1990, and reduced staff by 60%.

The agricultural sector has been restructured, declining in relative size as livestock numbers fell sharply. Productivity has risen strongly and farming is generally profitable despite the lack of government support and continuing barriers in many countries to New Zealand's exports.

More competition has emerged, with favourable effects on price, quality and availability, in domestic air transport, cars, consumer electronics and appliances, and financial services.

In spite of these successes, the jury is still out as far as economic performance as a whole is concerned. Since the early 1990s the economy has performed very well – strong growth, rising employment, stable prices – and the threat of a Latin America-style crisis and depopulation appears to have passed. But from the time that the exchange rate was floated in March 1985, allowing disinflationary monetary policies to become effective, New Zealand enjoyed little or no growth for more than six years, with employment falling by around 6%. And New Zealand continued to lose ground in international terms (Figure 1). The aggregate figures for the whole economy, furthermore, hide the extent of the adjustments that virtually all regions of the country were forced to make at one stage or another, but which occurred at different times. Signs are encouraging, but more time will be required before it will be possible to conclude that there has been a clear change in long-term trends or simply a strong cyclical correction after a long period of stagnation.

Social policies have been addressed less comprehensively although some changes have been made in housing, income support and health care.

The Politics of Reform

The Labour government came to power in 1984 with a clear mandate to do something, but it had given no indication of what it would do. Furthermore, most of the changes, taken individually, were controversial, and many were clearly unpopular. Yet the Government was returned in 1987 with an unchanged majority in Parliament, and, despite six years of virtually no growth, the reform process survived both a later loss of cohesion by Labour and a transfer of

power to the conservative National Party in 1990. The coalition government which came to power in late 1996 also appears likely to consolidate the bulk of the changes which have occurred. How was the reform process held together politically?

An important element of the answer is that the pace and sequencing of reform, an issue which has generated a good deal of nonsense in the economics literature, was geared to generating and sustaining support for it. Roger Douglas, the driving force behind the process as Finance Minister until late 1988, argued that the process should be fast, comprehensive and involve large packages that should keep coming until the process was complete. Successful reforms themselves would operate to build the necessary consensus. In this way, Douglas argued, the cost of reform in each area would quickly be offset from the benefits in other areas; rapid reform would keep the initiative in the hands of the government, while packaging groups of reforms together allowed losers from one set of reforms to be compensated as winners from another. By moving rapidly and boldly, Douglas and his colleagues made it difficult for vested interests to coalesce in opposition to reform and allowed the government to focus the debate broadly on the large problems the country had to confront, rather than narrowly on the impact of change on special interests. Indeed, rapid reform on a broad front tended to spread the burden of reform equitably, enhancing its perceived legitimacy.

Two observations should be added to this analysis. First, the comprehensive reform of the financial sector and the withdrawal of subsidies to agricultural shortly after the Labour government took office in 1984 played a major role in paving the way politically for the larger process by altering notions of what was possible. Notice had thus been served: radical action was possible, and problems would be addressed comprehensively. Furthermore, the direction of change had been mapped out clearly: institutions would be changed, individuals and businesses would make more of their own economic decisions and face responsibility for the consequences of their decisions, and the country had to adapt to a larger international economic environment.

Second, an unsung hero in these bold moves was the Prime Minister, David Lange. As his own Foreign Minister, he had plenty of problems unrelated to the economy to keep him occupied, and it would have been easy for him to remain detached from Douglas when the political heat turned up. In fact, when the going got tough, Lange stepped forward and took the worst of the pressure, spoke clearly and honestly about unpleasant realities that people did not want to hear about, and reaffirmed his support for both Douglas and the direction in which the reforms were taking the country. He never allowed his Minister of Finance to twist in the wind. So long as the Lange-Douglas relationship maintained its cohesion, there was no alternative to the reform process. By the time they fell out, in 1988, it was irreversible.

■ ■

The New Zealand experience clearly offers a rich array of ideas for other countries re-examining their own economic and social arrangements. Nearly all important aspects of its economy have been reformed to some degree or other, and in several a striking amount of radical, even path-breaking, thinking has been put into practical effect, not least in the public sector. New Zealand's widespread use of a contracting framework as a device to place responsibility for decision-making where those decisions can most intelligently be made, and to ensure accountability for them, is well worth close examination. The management of the political aspects of the process, too, and in particular the readiness of senior politicians to invest time and energy arguing, explaining, selling and defending the case for reform to the public, merits attention.

But there may be limits to the extent to which the New Zealand experience could be transferred. First, the social and political context differs across countries, which reduces the applicability of technocratic analyses and comparisons. It is important either to adapt reforms to the local context or to ensure that the persuasion and open debate keep the consensus and economic changes moving together. Second, a central focus now emerging in many countries is how to impose limits on the welfare state. Here New Zealand has made some cost-saving efforts, but little of a very fundamental nature has happened. The New Zealand experience may offer fewer lessons here. Finally, attempting to draw selectively and partially from the New Zealand experience to address only the 'most serious' problems may be difficult. As reforms are implemented, they can be expected to generate pressures that highlight problems and distortions elsewhere. In New Zealand, these were used to prepare the political ground for extending the reforms. If the process had not moved forward rapidly, political pressures for a reversal might have been difficult to resist. Reform along similar lines elsewhere may have to be complete or not at all. ■

OECD Bibliography

- **OECD Economic Surveys: New Zealand**, 1996
- Hannes Suppanz, 'New Zealand: Reform of the Welfare State', **The OECD Observer**, No. 200, June/July 1996
- Adrian Orr, 'New Zealand: The Results of Openness', **The OECD Observer**, No. 192, February/March 1995
- **OECD Economic Surveys: New Zealand**, 1994.