

# Commentary: Issues in 'Economic Transformation'

Frank Holmes

'Economic transformation' implies a desire to effect significant change in the form or character of the economy. I have lived through several economic transformations, and policies designed to transform the economy, in New Zealand. The most significant transformation was probably the large-scale transfer of manpower and other resources after 1939 from peacetime production to military purposes and the provision of food for armed forces in Europe, the Middle East and the Pacific, and then the return to a very regulated, insulated and corporatised economy, highly dependent on resuming the sale of pastoral commodities to what remained for some years a reasonably assured and profitable market in the United Kingdom. This facilitated the pursuit of policies giving priority to full employment, import substitution, the maintenance of 'fair shares' among the dominant interest groups and the improvement of health, education and welfare.

The next most significant was the transformation initiated by the Labour government elected after the economic crisis of 1984 and carried forward in the first term of the National government elected in 1990. The economy was opened up to greater competition from overseas; the New Zealand dollar was floated; the financial system was deregulated; the tax system was significantly reformed; and enterprises, private and public, were given more freedom to be innovative in competing to provide the goods and services that New Zealanders and customers overseas wanted.

New approaches to inflation targeting and independent administration of monetary policy, enshrined in the Reserve Bank Act of 1989, assisted the more competitive market to undermine the foundations of the old cost-plus economy with its inflationary bias, and selective government interventions which were distorting and put a premium on lobbying for government favours.

The reforms brought radical and beneficial changes in the management of the public sector, through the State Owned Enterprises Act of 1986, the State Sector Act of 1988 and the Public Finance Act of 1989. This legislation was usefully supplemented in 1994 by the Fiscal Responsibility Act, which imposed a medium-term focus on government expenditure, revenue and debt, thus providing a more satisfactory context for the planning and operation of fiscal policy and debt management.

This burst of policy transformation should not be interpreted as some slavish adoption of the 'Washington Consensus'. New Zealand was breaking away from many of the embedded attitudes, institutions and policies that most New Zealand economists had considered for many years needed to be changed, preferably at a well-planned and considered pace, if New Zealand was to adapt effectively to its changing external environment. The manner in which the initial burst of reform was carried out helped to generate considerable financial instability and some undue disruption of production and employment. The full benefits of the reforms in more rapid and stable expansion were not felt until about 1993.

The present government has accepted that most of these reforms should endure as part of the basis for economic transformation. The open economy has been accepted. 'No one', the minister says, 'wants to return New Zealand to being a fortress economy strangled by an overzealous government getting in the way of business.' The minister acknowledges in a footnote that fiscal discipline, protection of property rights and market determined interest and exchange rates are no longer controversial as policy prescriptions. He says that other elements of the 'Washington Consensus', such as an emphasis on flat taxes, excessive deregulation, wholesale privatisation and the removal of the state from any role in economic and industry development, have been discredited by experience.

New Zealand has not in fact tried flat taxes. The government has increased the top rate of personal income tax, which an increasing proportion of taxpayers now have to pay. The ratio of its revenues to gross domestic product has increased to some extent, but the ratio of its expenditures did not in its first two terms. Projections in the Budget Economic and Fiscal Update 2006 indicated that fiscal policy will become quite expansionary in the next two years, through both higher state spending on goods and services and higher transfer payments to households. Both government and opposition seem to agree that the present rates and structure of taxation need to be reviewed as an aspect of a sensible policy for economic transformation, but have differed strongly on what can be afforded, given their expenditure programmes.

As expected, the Labour government's legislation and regulation have moved in the direction of greater protection of employees in the labour market and increased holiday entitlements and minimum wages. It has also intensified industry specific regulation, particularly in electricity and telecommunications. Business continues to have concerns about the Resource Management Act and its administration, particularly inconsistency of decisions by different local bodies, long delays and multi-layered hearings and their cost. The minister's paper indicates awareness that central, regional and local government regulation must not unnecessarily impede the achievement of the worthy objectives set out in the government's vision for economic transformation. A review is in progress. Improvement in the quality of governance in each of those sectors must play an important part in plans and policies to implement the vision.

There would be little debate among most of our political parties that the state in New Zealand has a very important role to play in economic and industry development, but there would be considerable disagreement on how it should play that role.

New Zealand's current economic situation and outlook should make the implementation of a policy to achieve the broad objectives set out by the minister among the highest priorities of the major political parties over the next few years. Our rate of growth of production and productivity has been slowing down appreciably relative to the average of New Zealand's trading partners since 2004. The world expansion has helped to sustain good

commodity prices. Our more flexible economy has been helpful in sustaining reasonably stable terms of trade. Nevertheless, our expenditures overseas have been exceeding our receipts by unusually large margins that should cause concern. At the same time, inflationary pressures have been sufficiently strong to create severe labour shortages, especially of skilled workers. We have almost reached the limits of what we can do to get more people into work. The existing stock of business capital is being heavily utilised.

This not only emphasises the importance of greater attention to achieving higher productivity generally. If we wish to be a more active participant in the global economy, policies for economic transformation must give higher priority to ensuring that adequate investment and other resources flow to activities that are significant and effective contributors to earning or saving overseas exchange. In that respect, while recent governments have earned international respect for what appear to be sensible and conservative fiscal and monetary policies, developments in the private sector have led to New Zealand's exchange rate being sustained at levels that give greater incentives to spend overseas exchange than to earn it.

Our tax system and other elements of policy seem to offer unusually favourable incentives for New Zealanders to invest in housing and other perceived sources of capital gain. The banking system, which is the dominant source of finance, concentrates heavily on catering for that investment, considerably supplementing New Zealand sources of funds from relatively short term overseas sources attracted by New Zealand's relatively high interest rates. These high rates have not deterred New Zealanders from substantially increasing the ratio of household debt to household income to finance their spending on housing and equipment for their homes and personal enjoyment.

Their recurrent tendency to drive up the monetary values of residential and rural properties well above the income likely to be derived from them should get more attention in policy making, and not only because of the potential consequences when the bubble bursts. In the context of economic transformation, it would be desirable if a higher proportion of the country's investment were devoted to the sorts of developments outlined in the minister's paper. None of our major political parties seem to consider that the adoption of any

form of capital gains tax is politically realistic, but the issue should not be given the status of a sacred cow.

The recent developments in the financial system suggest that more attention should be given to whether New Zealand has the financial services on offer that will best enable the allocation of our resources to the most productive uses. In an important background paper recently issued by the Reserve Bank (Bollard, 2007), the governor and others suggest that there is room for further development of our unique financial market and institutional structure. 'This includes expanding the width and breadth of New Zealand's capital market, enhancing the performance of the non-bank financial sector, and raising the total pool of financial savings and financial literacy.' In doing so, the authors suggest, our financial system could be made more dynamic and sound, potentially helping to raise our sustainable economic growth performance. These considerations deserve attention, not only in their own right, but in the development of policy for the future of our Kiwi Saver and national superannuation programmes.

Our situation suggests that overall constraint will be needed in fiscal policy in the medium term, unless there is significant improvement in New Zealanders' propensity to save and a reduction in their willingness to incur debt. As the OECD pointed out in an Economic Outlook report last year (OECD, 2006), 'additional fiscal stimulus, whether in the form of tax cuts or additional spending, would reduce the room for lower interest rates and inhibit the transition to export-led growth', by making it less likely that monetary policy could be eased and currency depreciation induced.

Budgets will need to make room for the necessary increases of expenditure on infrastructure, the development of research, science and technology and its application to sustainable development and environmental improvement, and the improvements in education and training the minister envisages. Tax policy should give higher priority to fostering the aims of the transformation agenda rather than further stimulating domestic consumption. This will require greater attention to devising more effective means of achieving some of the other objectives of budgetary policy.

One of the greatest problems in planning is to get agreement on reducing expenditure on activities that

are no longer of high priority in order to make room to greater attention to activities that are. The 'detailed action plan for economic transformation' foreshadowed by the minister will have to be fitted into the government's overall fiscal planning. He recognises the need to work in a more coherent way across government and to better focus and target government resources as it attempts to foster innovation. Government itself needs to give a lead by more systematically formulating and publishing well-considered plans for the implementation of its own priorities over a period of years ahead.

Strategic leadership in the nation's longer-term interests is not easy for a democratic government with a three-year parliamentary term under the MMP system, especially when some politically unpleasant choices may need to be made. The minister's agenda is obviously influenced by the so-called new growth theory, which sees market forces and private entrepreneurship in the driving seat, but with governments performing a strategic and co-ordinating role in the productive sphere, working together with the private sector to discover the best options for profitable and sustainable economic development. The minister's paper hints that there are still problems for government in getting its own departments to work together constructively on the formulation and implementation of strategic policies. Strong leadership driven from Cabinet level on strategic planning and management in the state sector will be needed if it is to develop effective partnerships with the private sector and other levels of government in effecting transformation.

A severe test of government leadership is imminent because of the need for early, agreed decisions on co-ordinated policies on energy, transport development and land use, and New Zealand's approach to problems of climate change. Recent announcements by the prime minister seem to accord 'sustainability' at least as much weight as 'economic transformation' as an objective of policy. Reconciling these two objectives will be a challenge. For example, can we reconcile a set of policies directed to 'carbon neutrality' with those required to promote upgrading of the competitive strength and global connectedness of our economy? The minister displays a positive attitude in seeing the challenges involved providing opportunities to encourage New Zealand firms to develop and adopt new technologies that will advance both objectives, and potentially

provide future competitive advantages in a world facing similar problems.

Richard Prebble has rightly emphasised the importance of the quality of leadership and management in improving the productivity of state-owned enterprises. Shortage of skilled leaders and managers remains a problem that needs to be addressed, not only throughout the public sector but also in other sectors of the economy and society. In forging a Kiwi economic identity that we can celebrate, we need more leaders and managers throughout New Zealand – not just in Auckland – who become more globally connected. Permitting and encouraging state-owned educational institutions to sell their services to people from overseas demonstrated that such institutions could benefit both themselves and the country by internationalising their operations, provided that they were financially sound and sustained high qualities of service for both domestic and overseas participants in their programmes. If we are to make effective use of any success achieved by our government in WTO negotiations or in the partnerships it hopes to develop in the dynamic Asia-Pacific region, New Zealand needs to develop more leaders and managers who can find means of leveraging their capacity to produce goods or services with a competitive advantage on relationships they sustain with customers or associates overseas. Finding better means of attracting, developing and retaining highly talented people, including our own diaspora, in key positions in both the public and the private sectors must be high on the agenda of any effective programme of economic transformation.

## References

Bollard, A. (2007) 'Delivering sound and innovative financial services for New Zealand', background paper for an address to the Canterbury Employers' Chamber of Commerce, Reserve Bank of New Zealand, 26 January

OECD (2006) 'New Zealand', in 'Country summaries', *OECD Preliminary Economic Outlook*, 80, Paris: OECD, December, p.99

**Sir Frank Holmes is an Emeritus Professor of Victoria University of Wellington.**

## BEING ACCOUNTABLE: Voluntary Organisations, Government Agencies and Contracted Social Services in New Zealand

**An Institute of Policy Studies publication by Jo Cribb**

Governments in New Zealand and many other countries rely heavily on voluntary (or non-profit) organisations to deliver vital social services. However, the current contracting and funding mechanisms used to purchase such services on behalf of citizens are problematic for both funding bodies and providers.

*Being Accountable: Voluntary Organisations, Government Agencies and Contracted Social Services in New Zealand* explores the contracting relationship from the perspective of voluntary organisations. The central issue, it is argued, does not lie in the use of contracts per se, but in the relationships and practices used to generate them.

Published – November 2006

Format – A5 Paperback, pp 195

ISBN – 1-877347-15-9

Price – \$25.00 (including P&P within New Zealand)

To have a copy of *Being Accountable: Voluntary Organisations, Government Agencies and Contracted Social Services in New Zealand* and an invoice sent to you, please email, phone, fax or mail your order to:

### Institute of Policy Studies

Victoria University of Wellington

Email ipos@vuw.ac.nz

Telephone +64 4 463 5307

Fax +64 4 463 7413

PO Box 600, Wellington

New Zealand