The Institute of Policy Studies, School of Government at Victoria University of Wellington

# POLICY Quarterly

Volume 5 – Number 1 – February 2009

## Special Issue: Global financial crisis and its implications for New Zealand

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# Editorial Note

The financial crisis gripping the world since the latter part of 2008 has had profound and wide-range impacts – political, social, psychological and, of course, economic. There is doubtless a lot more to come, sadly much of it grim – although the full magnitude and duration of the economic impacts remain uncertain. Indeed, one of the more striking features of the past six months or so has been the enormous uncertainty generated by the crisis. Even seasoned economic forecasters and political pundits have been left baffled and have been forced regularly to revisit their basic assumptions, beliefs and projections.

More significantly, the crisis has posed serious policy dilemmas and intellectual challenges – challenges that are bound to occupy policy makers, as well as academics across a range of disciplines (including accounting, economics, law, management, political science and psychology), for many years to come. Quite properly, the crisis has prompted a vigorous questioning of many well-established *ideas, theories and policy settings*:

- *ideas*, for instance, about the capacity of markets to 'self-correct', the appropriate levels of risk and rewards, the design of corporate governance structures, and the role of trust, ethics, and responsibility in the functioning of market economies;
- *theories*, for instance, about 'efficient markets' (i.e. the notion that prices fully and efficiently reflect all the available information) and the nature and implications of globalisation; and
- *policy settings* in relation to such matters as inflation targeting, the regulation of financial markets, the merits or otherwise of public ownership of major businesses, the role of government subsidies and guarantees, and the design of social policies, such as unemployment insurance and housing assistance.

Not since the Great Depression has there been such a questioning of long-standing beliefs and accepted practices. Where this questioning will ultimately lead – especially in terms of the longer-term policy responses, both nationally and internationally – remains to be seen; but there can be no doubt that the world has changed, and changed fast and profoundly.

With these considerations in mind, this issue of *Policy Quarterly* begins with contributions from five New Zealand economists on aspects of the financial crisis and its implications. The articles are based on papers presented at an IPS forum on the financial crisis, in Wellington in November 2008.

Dennis Rose explores some long-standing issues facing the New Zealand economy, in particular the implications of the country's high level of net international liabilities and the risk this poses in the context of global financial shocks and a potentially protracted economic downturn. Geoff Bertram, likewise, examines New Zealand's high levels of indebtedness, focussing especially on the vulnerability of this country's banks (given their heavy reliance on offshore funding) and the merits of the government's decision in late 2008 to provide banks with a wholesale guarantee. Next, Brian Easton considers how the current financial crisis compares with previous cycles and depressions in New Zealand's economic history and asks, amongst other things, whether the current difficulties are the same or different. His answer, in short, is both 'yes' and 'no'. Following this there are two articles on some of the issues that the financial crisis raises for social policy. Bob Stephens explores what might happen to social policy expenditure and policy settings in New Zealand under three possible scenarios: a mild recession; a moderate to severe recession of a long duration; and a prolonged severe recession. He assumes that there will be a centre-right government in office, at least during the current parliamentary term. Next, Michael Fletcher outlines a number of priorities and principles for the design of social policies during a recession. He gives particular attention to three policy areas – employment support, training and education, and benefits and tax credits.

These articles, needless to say, touch on only a few of the theoretical and policy issues that deserve attention in the wake of the global financial crisis. I trust that future issues of *PQ* will address many other topics of relevance to the crisis and, in so doing, contribute to the wider public debate and the framing of policy responses.

This issue of *PQ* concludes with a series of articles on four very different matters. Dennis Rose (in his second contribution to this volume) identifies the major issues likely to arise should New Zealand embrace a republican constitution, particularly those relating to the role and powers of the head of state. The final three articles offer perspectives from a number of distinguished overseas academics. Evert Lindquist explores contrasting narratives of public sector reform; Martin Lodge analyses the nature of public sector bargains (between politicians and senior public servants); and Brenda Bushouse considers the rationale for, and merits of, the recent introduction of 20 hours free education for three and four year olds in New Zealand. Notwithstanding the current financial crisis and impending large fiscal deficits, this policy seems destined to endure, albeit in a modified form.

Jonathan Boston

Dennis Rose

# Overseas Indebtedness, Country Risk and Interest Rates

### Introduction

The origins of the current international crisis lie outside New Zealand, but New Zealand's high level of net international liabilities has long exposed us to the possibility of a sharp correction. In what follows I focus on some longstanding problems, to which I see no easy answers, which are likely to be with us for many years. But first, two introductory comments.

Obviously, what lies ahead is quite uncertain, but it seems clear that the world is entering a prolonged downturn. Falls in equity prices and difficulties in access to credit are compounded by falling price levels and reductions in demand which will flow on to reductions in output, company failures and increased unemployment. How bad it will be we do not know, but financial shocks on the scale that we have observed take years rather than months to work out.

Second, although the international forces acting on our economy are beyond our control, we are able to influence their impact on the New Zealand economy. Mistakes are going to be made, but hopefully we can minimise those by ongoing dialogue within and beyond the policy-making community. At times of crisis those in positions of responsibility are required to make large judgements at short notice. They quite reasonably expect continuing support, but that support needs to be critical. There are difficult and contentious issues in front of us, which demand constructive attention and ongoing dialogue.

**Dennis Rose**, a research economist, is a Senior Associate of the Institute of Policy Studies. His recent work has focused on the implications of New Zealand's ongoing current account deficits.

### Balance of payments deficits and the net international investment position

The Reserve Bank's 2008 Financial Stability Report discusses New Zealand's external position. Three features stand out.

1. Since 2000, and indeed for many years before that, New Zealand's current account balance (the net balance between exports and imports of goods and services and international factor payments) has been in deficit. The deficit deteriorated during the decade and for the last few years has averaged around 8 to 9% of GDP.
2. Current account deficits have to be financed by drawing on overseas capital in one form or another. Total net international liabilities have been slowly rising, from a low point equal to 75% of GDP at the end of 2001 to a contemporary high of 89% in March 2008.
3. The proportion of net international liabilities accounted for by net international debt has been rising relative to that part reflecting equity investment (including foreign direct investment). The ratio of net international debt to GDP has risen from around 60% in 2003 to 83% now.

Debts must of course be serviced. Net international liabilities on the scale reported above imply a heavy servicing requirement. It is a striking fact of recent New Zealand history, again focusing on the period from 2000, that net international investment income payments, which have varied between 6 and 8% of GDP, are roughly equivalent on average to the balance of payments current deficit as a whole. In contrast, exports and imports of goods and services, whilst fluctuating, have been in approximate balance over this time. In a very real sense New Zealand has been borrowing to pay the servicing requirements of its international debt.

This relationship is also illustrated in the Financial Stability Report (Reserve Bank of New Zealand, 2008, Figure 4.1), which shows the approximately equivalent total values of cumulative current account deficits and the parallel increase in the net foreign liabilities of banks operating in New Zealand. Implicitly, New Zealand has become habituated to a steady inflow of bank-mediated funding from foreign residents to finance continuing balance of payments deficits.

Continued access to this flow has now been put at risk by the international financial crisis. The New Zealand government, following other countries, has introduced opt-in guarantee schemes in an attempt to reassure foreign investors that deposits with New Zealand banks are secure. How effective this will be has yet to be seen. All systems of guarantees have their downsides, including untoward incentive effects, and there must be some risk that the guarantee may be called, imposing significant costs on government, taxpayers and citizens.

**Net international investment positions and interest rates**

New Zealand is not alone in having a large ratio of net international liabilities to GDP but, as is apparent from Figure 1, it is among the leaders in the field. Figure 1 is drawn from research in progress on the relationship between net international investment positions and national interest rates (Rose, 2007). The clear implication of the scatter plot of mean values for the period 1980–2004 is that countries with higher levels of net international indebtedness have higher interest rates. Broadly, countries that hold roughly equal amounts of international liabilities and assets can access international short-term money at around 3%. Countries such as Switzerland, which has net assets equivalent to 100% of GDP, can tap into markets at very low rates. Countries such as New Zealand find themselves paying significantly higher rates of interest. Effectively the market is pricing country and/or currency risk into national interest rates.

Whilst the existence of country or currency risk margins is widely noted, much theoretical discussion on the balance of payments proceeds as if they did not exist or are of little consequence. Standard textbook models typically see balance of payments deficits as reflecting essentially short-term inter-country differences in investment opportunities and savings patterns. With a common core 'world interest rate', capital flows between countries are seen as responding to those differences, leading to changes in investment, output and income patterns which in time enable the servicing and repayment of debt.

There are substantial elements of truth within this story, but it is not the whole story. A number of writers have suggested that national interest rates will contain risk premia related to national balance sheets, such as are evident in the cross-country data in Figure 1. The key contrast between the core model story and our data-based exploration is the slope of the interest rate function. In the standard model the world interest rate is a constant, horizontal line. Figure 1 shows a sloping function. Interest rates rise with increases in net liabilities.

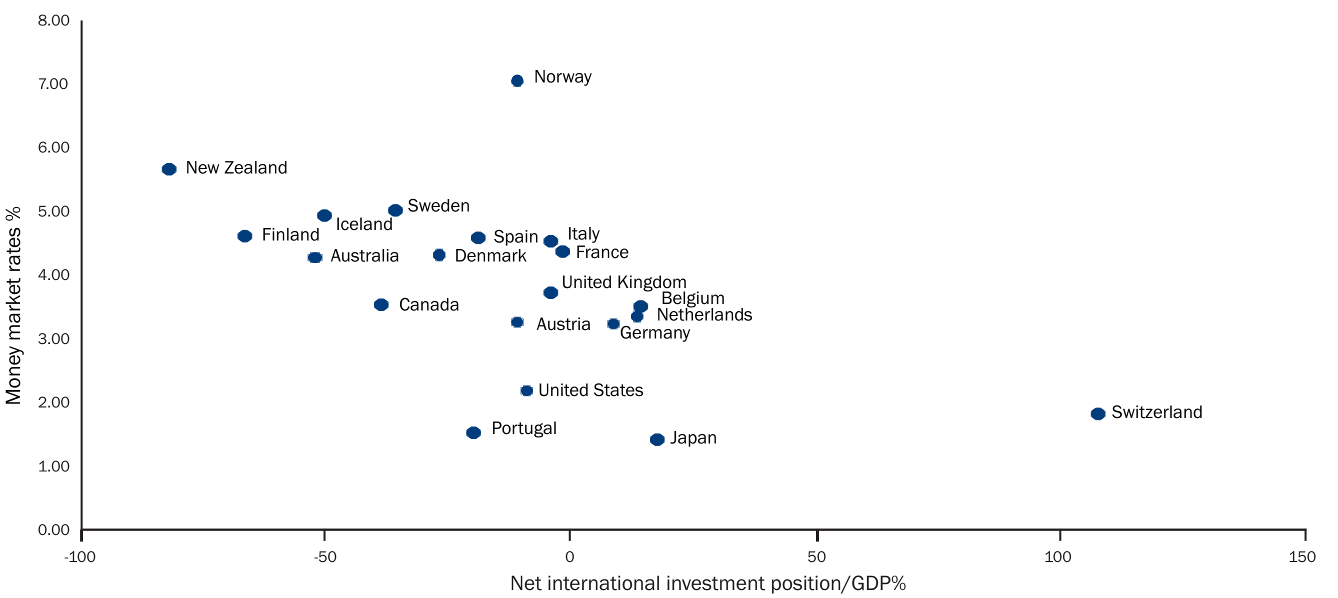
The standard two-country model focuses on national flows of investment and savings, and the current account balance as the flow difference between them at the prevailing world interest rate. In our graph of the actual data we are looking at the net international investment positions resulting from the accumulation of current account balances over time. It is this long accumulation of a stock of international net liabilities that generates risk premia.

The scale of the effect of net international investment positions on interest rates can only be approximated because interest rates reflect a number of influences, but on my estimation New Zealand's current level of international net liabilities implies a wedge of something like 1½% above the short-term interest rate levels that would prevail were our international liabilities and assets in balance. In fact, New Zealand's short-term interest rates have, since 1990, averaged some 2¾% above the average level of those prevailing in our TWI partner countries (the United States, Euroland, Australia, Japan and the United Kingdom). What might explain the additional element within the overall differential? Again, many factors are likely to be present, but some of us argue that the central and all but exclusive focus of New Zealand monetary policy on inflation control is a significant cause. Note that this influence reflects both the design of the statutory rules under which the Reserve Bank operates and the choices made by the bank in operating those rules.

I don't propose to develop that argument here. Instead I shall focus on the implications of the large existing real interest rate differential, whatever its cause may be. I note four effects. The importance of each of these needs to be assessed within an appropriate framework.

1. Because the country/currency risk premium increases with the level of debt, the rate of debt service payments increases at an accelerating rate as national debt levels increase. The effective constraint on ever-increasing net international investment position (NIIP)/GDP ratios is imposed by the cost of servicing rather than the interest rate alone.
2. Interest rates present investors with a screening test. The rates of return that an investor expects to realise by undertaking an investment need to be sufficient to service the debt used to finance that investment. High interest rates reduce the number of investments that pass this test and thus act to reduce the level of capital formation. They thus inhibit growth.
3. Rates of return on real productive investments are constrained, at any point in time, by the technologies currently available. High interest rates encourage investors to focus on markets in which there are apparent opportunities for high returns and thus, arguably, bias

**Figure 1: Net international investment positions and real interest rates**



investment towards areas in which there are prospects for gains from asset inflation rather than from increases in productive capacity.

4. High real interest rates have an observable effect on nominal and real exchange rates (the real exchange rate is the nominal exchange rate adjusted for differential movements in prices between New Zealand and the other countries party to the exchange rate).

I make no further comment the first three effects except to say that I think they are problem areas. The exchange rate linkage, which is illustrated in Figure 2, is, however, central to my story.

**Interest rates and exchange rates**

The clear implication of Figure 2 is that higher New Zealand interest rates (measured relative to the weighted average of our principal trading partners and displayed on the horizontal axis) induce higher exchange rates. The scale of the effect is substantial and can be approximated by a simple linear regression:

RERTWI = 41.08 + 6.853*INTEREST     *$R^2$ adjusted = 0.58*
(0.000) (0.000)     *p-values in parentheses*

where RERTWI is the International Monetary Fund's real exchange rate index for New Zealand scaled to give the same mean as the nominal TWI for the period 1990–2007, and INTEREST measures the difference in real short-term interest rates between New Zealand and in the countries within the TWI basket, appropriately weighted. Real rates are nominal rates deflated by changes in consumer prices.

A one percentage point change in the real interest rate differential (e.g. from 2% to 3%) shifts the real TWI by about 6.9 points relative to its 1990–2007 mean of 60.1. Absent the differential, the TWI would, implicitly, fall to around 41. These are very substantial effects.

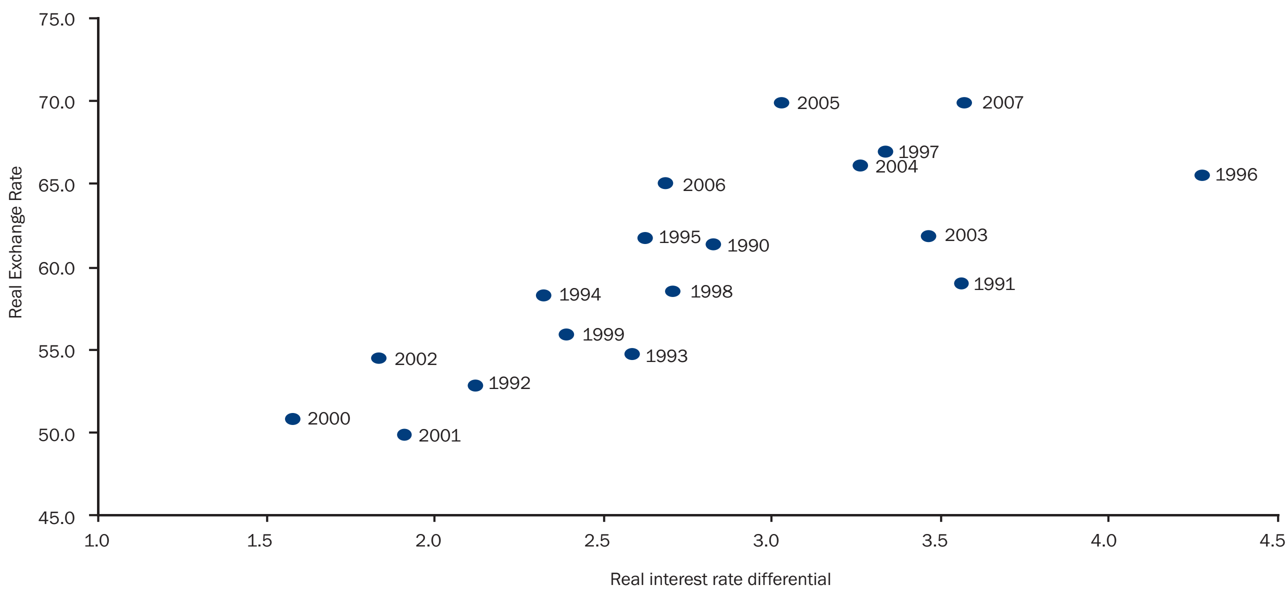
As noted, the interest rate differential reflects a number of influences. On the numbers sketched above the high level of net international liabilities contributes more than half that differential, with the rest being due to monetary policy rules, application of those rules, and other influences whatever those might be.

**Exchange rates and the balance of payments**

By common consent the exchange rate is an important variable influencing the level and pattern of import and export flows. High exchange rates tend to encourage imports and to discourage exports. However, floating exchange rates are highly variable, so that it is difficult to trace their actual impact on trade flows. In an earlier paper (Rose, 2001) I used lagged relationships over three-year periods in an attempt to see through this short-term variability. I explored the influence of exchange rates as one of a set of competing influences on the levels of exports and imports over three-year time periods. Export and import data were each disaggregated into nine groups. Other modelled factors included the cyclical behaviour of capital formation, the phasing down of import protection and technological change.

The study needs updating but the results remain relevant. The main findings were that exchange rate levels appeared to exert a significant influence on the level of exports but had little influence on imports. Variability in the exchange rate appeared to inhibit exports and, to a lesser extent, to encourage imports. The quantitative effect suggested by the regressions was that a rise in the real TWI by 10 units, e.g. from 50.0 to 60.0, 'would lead to a deterioration in the balance of payments, stemming from changes in export and import ratios, equal to about 2.7% of total supply or about 3.6% of GDP'. In addition, I concluded that variability in the exchange rate over the reference period of the study, 1988 to

**Figure 2: Interest rates and the exchange rate**



2000, was likely to have caused an annual negative effect on the balance of exports and imports equal to about 1.5% of GDP. Taken together these are substantial effects, amounting to some 5% of GDP, which as it happens is the average value of the current account deficit for the period 1990 to date.

A scatter plot of the real exchange rate against the current account balance provides another perspective on this story. There is a clear suggestion of a negative relationship between the exchange rate and the balance of payments. A linear function fitted to this data suggests a somewhat weaker influence than implied by my 2001 paper. In this case a 10 point change in the real exchange rate index, around its mean value of 60, would imply a deterioration in the balance of payments by around 2% rather than the 3½% suggested in the previous paragraph.

Clearly, there is a margin of uncertainty here, but even the lower of the two estimates is, in context, a significant number.

Possibly the international crisis will be short-lived, although that seems unlikely. Hopefully our systems will handle it better rather than worse ...

**The story so far**

To this point I have argued that New Zealand's very high level of net international liabilities introduces a risk premium into New Zealand's interest rate structure, which is additional to the upward pressures inherent in the monetary policy framework. Higher interest rates tend to raise the real exchange rate, which in turn acts to increase the balance of payments deficit. We now complete the circle. Balance of payments deficits must perforce be financed, and this financing adds to liabilities and so tends to increase the NIIP/GDP ratio.

**Changes in the NIIP/GDP ratio**

Again, this is no more than a tendency because the balance of payments is only one of three components driving changes in the ratio of net international assets to GDP. The three components are (1) the rate of change in nominal GDP (which itself is the product of the real rate of growth and the rate of inflation); (2) the capital flows arising from the balance of payments; and (3) revaluations of the opening stocks of international assets and liabilities.

$$\frac{N_t}{Y_t} = \frac{N_{t-1}}{Y_{t-1}} \times \frac{1}{(1+r_t)} + \frac{C_t}{Y_t} + \frac{R_t}{Y_t}$$

where

Nt = net international investment position at end of year t,

Yt = gross domestic product in year t,

r = the annual rate of growth in nominal GDP in year t,

Ct = capital flows financing the current account balance in year t, and

Rt = revaluations of international assets and liabilities in year t.

Interest rates and other rates of return lie behind each component of this equation. Rates of return are related to the rate of productivity change and thus help determine r. Their importance within the current account balance is an increasing function of the absolute value of the NIIP/GDP ratio. Finally, they are important determinants of the present value of international assets and liabilities so that changes in interest rates and other rates of return are important drivers of R.

'Wedges' between world and national interest rates contribute to the evolution of net international investment positions, which, in turn, exert a significant influence on national interest rates. This circularity raises questions as to causal direction, but the persistence of NIIP ratios and the short-term and cyclical variability of interest rates suggests that the predominant causation is from the former to the latter.

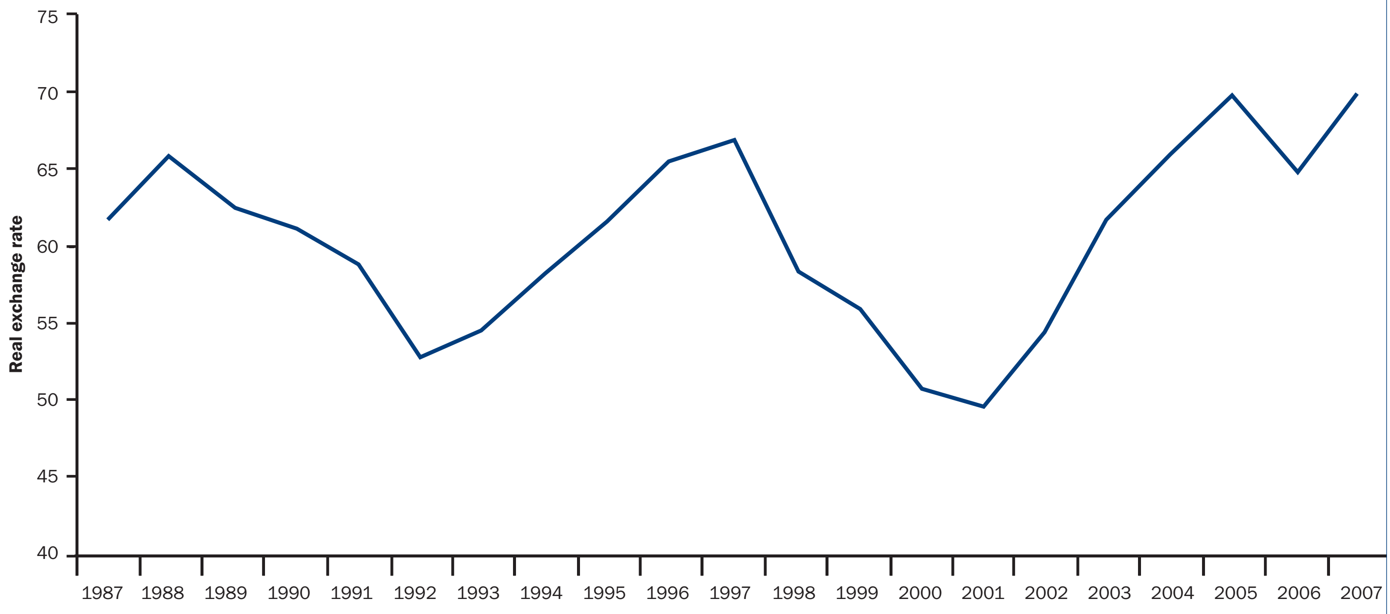
That said, interest rates do help to determine NIIP positions, both directly through their impact on international factor flows, and indirectly by their influence on exchange rates. This mutually-reinforcing process raises questions about the time spans and processes by which countries such as New Zealand, with large negative NIIP balances, can improve their position.

New Zealand's net international liabilities exceed 85% of GDP and recent current account deficits have averaged around 8% of GDP. The usual inter-temporal borrowing story implies that net international liabilities will at some point begin to reduce. Suppose that we hypothesise movement towards a balanced net external asset position over a 50-year period, and suppose that we could find a financial institution prepared to consolidate the present value of all New Zealand's international liabilities and assets in a single table mortgage at a real interest rate of 5%. Servicing that mortgage would imply that we, our children and our children's children would be required to run a 50-year balance of payments surplus in excess of 5% of GDP.

But this is too pessimistic a conclusion. In reality, inflation will provide part of the answer. Even in contemporary low-inflation environments, inflation undermines the value of debt denominated in nominal terms. Fifty years' inflation at 3% will reduce the real value of a debt by more than three-quarters.

Writing on this topic 12 months ago, I concluded that it seems inescapable that for several decades New Zealand will be exposed to the possibility that one or other external shock

**Figure 3: The real exchange rate**




will interfere with movement towards a more easily sustainable NIIP position and deliver a destabilising revaluation of international assets and liabilities. That exposure heightens the importance of ongoing attention to issues of prudential management and to international linkages and arrangements that help spread country risk. (Rose, 2007)

We are now experiencing such a shock. Possibly the international crisis will be short-lived, although that seems unlikely. Hopefully our systems will handle it better rather than worse, but clearly we have to expect difficult times.

### Implications

Looking through that period of adjustment and beyond, two major issues stand out, both of which require renewed theoretical attention.

1. The current crisis underlines, and indeed amplifies, the risks inherent in running high levels of net international liabilities. What lessons should we draw from that? What policies have contributed to this exposed position and what policies might have avoided it? Looking ahead, what policy adjustments are needed to reduce New Zealand's degree of exposure to external credit shocks? A theoretical puzzle underlies these questions. New Zealand's exposed international investment position is the outcome of a myriad of individual transactions, in which pairs of transactors have agreed to exchange capital sums now against future streams of income. If those transactions were by and large well informed, should we conclude that the overall outcome is in fact acceptable and sustainable? If not, at what points along the way does the logic break down?
2. Secondly, in my view the floating exchange rate regime has itself contributed to the evolution of New Zealand's highly indebted position. Figure 3 displays annual values for the real exchange rate (IMF real exchange rate series scaled to mean of TWI for the same period). The pronounced cycles in the real exchange rate are themselves a direct disincentive to exporting and, compounding with the wedge introduced to the average exchange rate by New Zealand's risk premium, have contributed directly to our level of international liabilities.

A floating exchange rate has of course many advantages, and I do not suggest we should discard it lightly, or that we have to hand a ready-made, well-articulated alternative. We do not. But I suggest we do need to look carefully at the links between the current floating regime and our debt position, to assess the workings of floating regimes over time spans that include major shocks such as the present, and to devote time to the articulation of alternatives.

So I end with a standard call for more research and discussion on alternative policy regimes. I don't apologise for that. These are theoretically contested areas and it is important that those with different views engage in discussion and debate. Meantime, people in positions of authority in times of crisis must perforce make their judgement calls on the basis of their understanding of relevant theory. The research community's job is to argue, test and develop that theory.

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Geoff Bertram

# The Banks, the Current Account, the Financial Crisis and the Outlook

Some years back I wrote two papers (Bertram, 2001, 2002) about the current account, the exchange rate and the banks. Here I pick up the threads of my earlier analysis as the backdrop to some remarks about the recent decision of the New Zealand government to provide a wholesale deposit guarantee to this country's New Zealand-incorporated – but mainly Australian-owned – banking sector.

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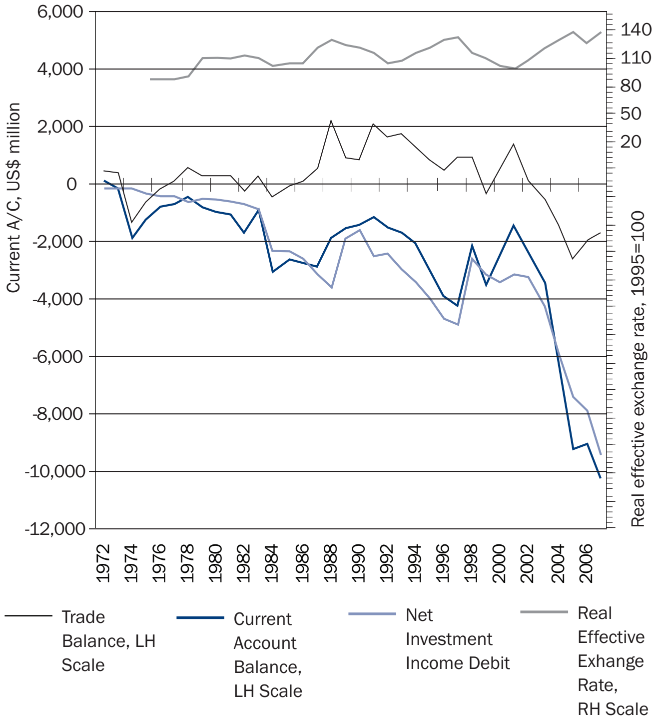
The first paper was subtitled 'Might New Zealand face a transfer problem?' The issue as I saw it was that continuing high current account deficits must necessarily imply a run-up of overseas debt, whether in the form of offshore ownership of assets in New Zealand or via portfolio flows to fund borrowing by New Zealand residents. This debt would have to be serviced, which would mean a growing outflow on the investment-income account of the balance of payments. This in turn would require a growing stream of foreign currency funding to meet those obligations, which could be secured either by improved net export performance or by further offshore borrowing.

The second paper (Bertram, 2002) focused on my realisation that, following the Asia crisis of 1997–98 and the accompanying sharp downturn in foreign direct investment flows into New Zealand, the hole in the New Zealand balance of payments had been filled (and the exchange rate of the New Zealand dollar kept afloat) by an extraordinary inflow of foreign currency deposits into the New Zealand banks from their overseas owners.

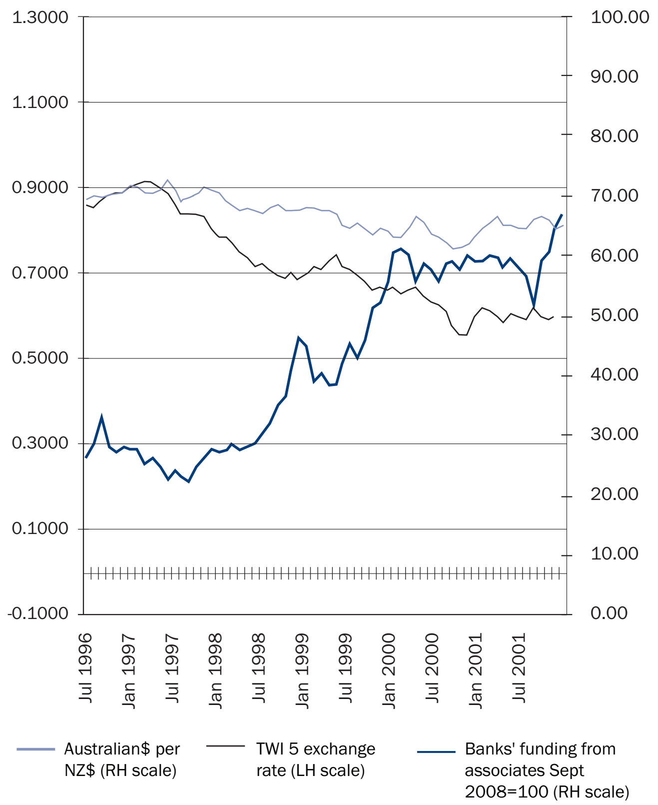
This paper brings the data and the story up to date as of late 2008. I find that in the decade following the Asian crisis, the banks' offshore funding activities have dominated the continuing rise in New Zealand's external debt, sustaining in the process a high exchange rate and large current account deficit. The global credit crunch reached New Zealand initially as a bank funding issue; the bulk of the economy's net external indebtedness sits on the banking sector's balance sheets; and the first big fiscal policy move in response to the crisis was a taxpayer guarantee of deposit funding for the banks.

**Figure 1: The current account, the trade balance (goods and services) and the real exchange rate, 1972–2007 calendar years**




Sources: IMF, *International Financial Satistics;* Statistics New Zealand data; Tripe (2004), Table 2; updated data from David Tripe

**Figure 2: Offshore bank funding and two exchange rates**




Source: Reserve Bank of New Zealand data

Figure 1 shows that since the 1970s the real exchange rate has trended up while the current account of the balance of payments has trended downwards – precipitously since 2002. The widening current account deficit has been effectively identical with the rising cost of servicing offshore investors' stake in the New Zealand economy (the 'investment income deficit') and has been funded by incurring further international liabilities. The proportion of that net outflow of investment income attributable to the banks rose from one third in 1997 to about 70% by 2008.

Figure 2 shows the arrival of the banks as a major force in the balance of payments in the late 1990s. The onset of a downward trend in the New Zealand dollar exchange rate in mid-1997 was quickly followed by the injection of $22 billion dollars of deposits into the New Zealand banks by their offshore associates (parents) between June 1997 and December 2001. The effect of this boost in the supply of foreign currency to the foreign exchange market was to check the fall in the TWI exchange rate and nearly stabilise

**Table 1: Current account flows and bank outflows of accruing profits and interest: $ billion**

| | Current account balance | Investment income debit | Outflows attributable to the banks | Banks' share of income debit |
|---|---|---|---|---|
| 1988 | -2.3 | -4.5 | | |
| 1989 | -0.5 | -3.9 | | |
| 1990 | -2.9 | -5.0 | | |
| 1991 | -2.3 | -4.7 | | |
| 1992 | -2.3 | -5.5 | | |
| 1993 | -2.7 | -4.4 | | |
| 1994 | -3.0 | -5.7 | | |
| 1995 | -4.0 | -7.0 | | |
| 1996 | -5.0 | -8.0 | | |
| 1997 | -5.8 | -8.5 | -2.8 | 33 |
| 1998 | -5.4 | -8.5 | -3.1 | 37 |
| 1999 | -4.4 | -8.2 | -2.8 | 34 |
| 2000 | -7.0 | -9.5 | -3.8 | 40 |
| 2001 | -5.1 | -9.0 | -4.6 | 51 |
| 2002 | -3.9 | -9.3 | -4.8 | 52 |
| 2003 | -4.5 | -9.6 | -4.9 | 51 |
| 2004 | -6.7 | -10.0 | -4.6 | 46 |
| 2005 | -10.3 | -12.3 | -6.0 | 49 |
| 2006 | -14.6 | -13.3 | -7.8 | 59 |
| 2007 | -13.8 | -14.7 | -9.1 | 62 |
| 2008 | -14.2 | -17.1 | -11.7 | 69 |

Sources: Current account data from INFOS; banking sector data from David Tripe the New Zealand–Australia cross exchange rate (that is, the rate that determined whether the Australian parent banks suffered capital losses on the New Zealand dollar lending of their New Zealand affiliates).

Bertram (2002) showed that the New Zealand banks continued to expand their local economy lending at a steady pace between 1997 and 2002 despite a drying up of New Zealand resident funding, with the gap filled by the inflow of funds from offshore. The relevant chart is reproduced as Figure 3.

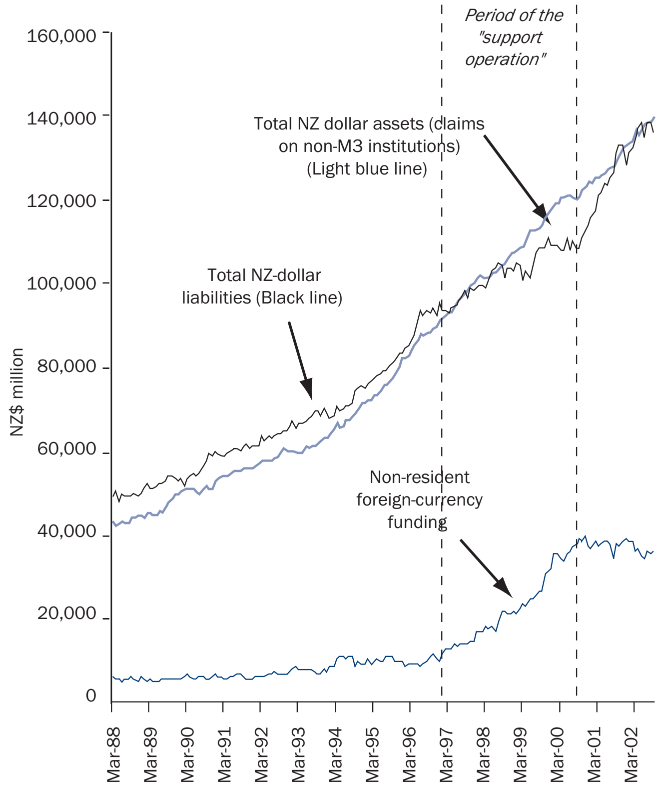
The conclusion I reached was that 'in the absence of this large-scale extension of short-term credit by overseas parents to their New Zealand bank affiliates, the nominal exchange rate would have been under far greater downward pressure during 1999. Indeed, one might speculate that, without this private-sector substitute for an activist central bank, the economy might have faced a classic financial and exchange-rate crisis in the wake of the Asian meltdown' (Bertram, 2002, p.195).

By early 2002 the New Zealand dollar liabilities of the banks had accelerated to catch up with New Zealand dollar assets, suggesting that the shortfall of local currency funding from 1997 to 2001 had been a one-off aberration, and there I left the matter in 2002.

Extending the series to September 2008, as in Figure 4 below, shows that in the past six years the offshore funding of their balance sheets with which the banks experimented in the late 1990s has returned with a vengeance and become something of an addiction. By September 2008 the gap had widened to a $58 billion shortfall of New Zealand dollar funding relative to New Zealand dollar assets, and a $98 billion dollar shortfall of New Zealand dollar funding from New Zealand residents on the liabilities side, relative to the banks' $278 billion of outstanding New Zealand dollar claims on New Zealand residents on the assets side. The banks have moved to offshore funding on a grand scale to finance domestic credit expansion within New Zealand, much of which went to fund speculative activity in the housing and property markets.

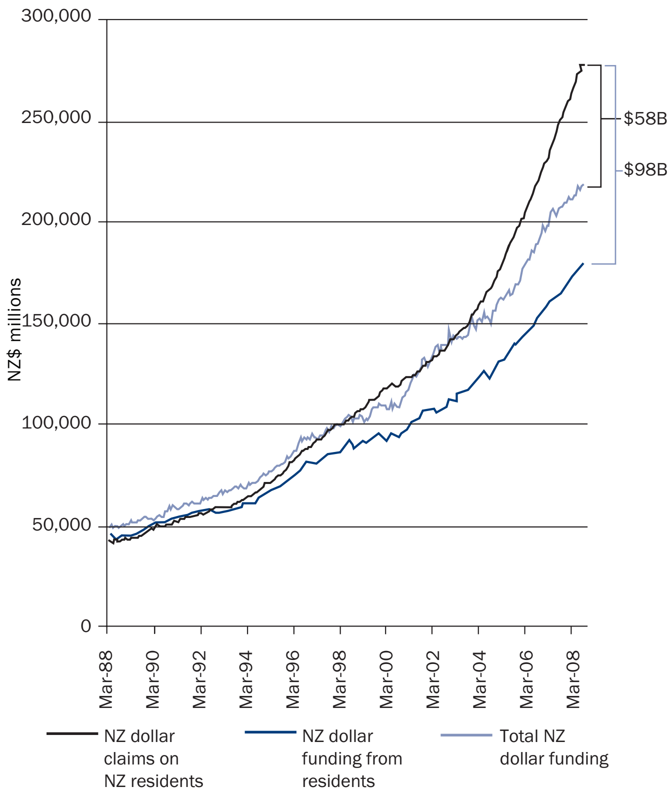
The Reserve Bank of New Zealand's recent Financial Stability Report (Reserve Bank of New Zealand, 2008, p.27, Figure 8) confirms that this flow of offshore funding has matched the current account deficit, enabling the economy to maintain its import levels without running into a foreign exchange constraint. Over the decade from March 1998 to June 2008 the cumulative current account deficit was $88.42 billion, while the cumulative increase in the banks' net foreign liabilities was $79.69 billion. To a first approximation, the current account deficit has been fully funded by the banks' offshore borrowing. More dramatic still, over the five years from June 2003 to June 2008 the cumulative current account deficit was $62.14 billion and the increase in the banks' net foreign liabilities was $71.97 billion, which means that New Zealanders were investing (net) overseas to the tune of a cumulative $10 billion, with the banks fully funding this as well as the current account deficit.

**Figure 3: Funding the growth of M3 institutions' New Zealand dollar assets**




Source: Bertram (2002), Figure 6

**Figure 4: Funding of New Zealand banks, March 1988 to September 2008**




Source: Reserve Bank of New Zealand, Table C4

**Table 2: Consolidated banks balance sheet**

| | Liabilities, capital and reserves | Aug 08 | Sept 08 | Assets | Aug 08 | Sept 08 |
|---|---|---|---|---|---|---|
| | **NZ dollar funding** | | | **NZ dollar claims** | | |
| 1 | NZ resident | 177.6 | 179.6 | NZ resident (Non M3) | 277.2 | 277.9 |
| 2 | Non-resident | 40.0 | 39.0 | Non-resident | 7.6 | 9.0 |
| 3 | Total 1+2 | **217.6** | **218.6** | Subtotal to here | ***284.9*** | ***286.8*** |
| | | | | | | |
| | | | | NZ resident (M3 institutions) | 15.0 | 15.1 |
| | | | | Total | 299.9 | 302.0 |
| | | | | | | |
| | **Foreign currency funding** | | | **Foreign currency claims** | | |
| 4 | NZ resident | 10.2 | 9.9 | NZ resident | 4.0 | 4.2 |
| 5 | Non-resident (?all wholesale?) | 80.1 | 80.7 | Non-resident | 11.6 | 6.6 |
| 6 | Total 4+5 | 90.3 | 90.7 | Total | 15.6 | 10.8 |
| | | | | | | |
| 7 | Capital and reserves | 22.6 | 22.5 | Foreign currency fixed assets and equity investment | 0.1 | 0.1 |
| 8 | Other liabilities | 19.6 | 27.9 | Shares in NZ companies | 0.4 | 0.4 |
| | | | | Other assets | 25.4 | 35.0 |
| | | | | | | |
| | | | | NZ government bonds and Treasury bills | 1.5 | 1.4 |
| | | | | NZ notes and coin | 0.5 | 0.5 |
| | | | | Claims on the Reserve Bank | 6.7 | 9.3 |
| | | | | | | |
| | **Total liabilities** | **350.1** | **359.6** | **Total assets** | **350.1** | **359.6** |
| | | | | | | |
| | Memo items: | | | Memo items: | | |
| 9 | funding from associates | 50.7 | 50.4 | financial claims on associates | 7.1 | 6.6 |
| # | total non-resident funding | 120.1 | 119.7 | total non-resident claims | 19.2 | 15.6 |

Source: Reserve Bank of New Zealand

It remains an open question whether the driver for this process was a 'hoover effect', as rising local demand for credit sucked in funds from abroad, or a force-feeding exercise in which the banks aggressively expanded their local lending in order to lend out locally funds which they were able to raise more cheaply offshore. Probably the answer is a bit of both. The two key outcomes, however, are not in doubt:

- a banking system with large outstanding, often short-term, offshore debt liabilities and large longer-term assets in New Zealand dollars. This balance sheet structure as at September is in Table 2. It presents no obvious risk of long-run insolvency, since the asset position is solid in local currency terms. There is, however, an obvious risk of a collapse on the liabilities side if access to offshore funding were to dry up, as it finally did in September 2008;
- a banking system which dominates both the investment income debits on the balance of payments current account and the liabilities side of the country's international investment position (see Table 3 below).

**Table 3: New Zealand international investment position at June 2008, $ billion**

| | | | |
|---|---|---|---|
| **New Zealand's international assets** | | | |
| Equity assets | 52.1 | | |
| Lending | 77.7 | | |
| *Banks* | | ***21.7*** | <— |
| *General government* | | 9.0 | |
| *Monetary authorities* | | 20.2 | |
| *Other sectors* | | 26.8 | |
| Total international assets | | **129.8** | |
| **New Zealand's international liabilities** | | | |
| Equity liabilities | | 63.1 | |
| Borrowing | | 225.9 | |
| *Banks* | | ***138.9*** | <— |
| *General government* | | 17.6 | |
| *Monetary authorities* | | 0.3 | |
| *Other sectors* | | 69.1 | |
| Total international liabilities | | **289.0** | |
| **New Zealand's net international asset position** | | | |
| **Net international equity** | | **-11.0** | |
| **Net international debt** | | **-148,176** | |
| **Net international asset position** | | **-159,194** | |

Source: Statistics New Zealand, *Hot Off the Press*

The banks, in summary, account for nearly 70% of investment income debits on the balance of payments, and for 74% of the economy's net overseas indebtedness.[1]

### A looming transfer problem?

Suppose that the availability of offshore credit for the New Zealand economy were to dry up while nothing else changed. In that case, unless the country were to default on its external debt, a transfer of domestic resources into export production and/or import substitution must occur, to an extent sufficient to create a trade surplus great enough to cover debt servicing. This is the 'transfer problem' which Keynes predicted in 1919 in the wake of the imposition on Germany of heavy reparation payments at Versailles. So long as the required domestic resource reallocation is feasible, there is no 'problem' – just downward pressure on home living standards as final output is diverted from local consumption and investment to overseas markets. If the required squeeze goes beyond feasible limits (or the political tolerance of the populace), then either default or offshore borrowing must follow, by the inexorable logic of the macro identities within which a national economy must operate.

Keynes conducted his analysis on the assumption that the reparations transfer would have to be entirely domestically funded, and calculated that the German economy would be unable to sustain the required level of production for export. In a famous debate with Keynes in 1929, Ohlin argued for offshore borrowing as the safety-valve. Germany indeed took that route in the late 1920s, as did New Zealand in the 1990s and 2000s. By 2000, the New Zealand economy had built up net external indebtedness equivalent to 80% of its GDP.

Summing up, the stylised facts from the past couple of decades are:

1. New Zealand has since the 1970s financed a persistent current account deficit by borrowing offshore, in three sucessive waves.
   a. The first, from 1975 to the late 1980s, was led by government borrowing which ran the total overseas debt up to 70% of GDP, of which the government accounted for about half.
   b. The second, during the sell-off of state assets during the 1990s, saw the overseas debt privatised, as the government retreated to funding its financing needs by the issuing of New Zealand dollar-denominated debt. At the conclusion of this surge of inward equity investment, about 1997, the gross external debt stood at $113 billion, of which half was direct private investment, and the net debt stood at $86 billion, of which $44 billion was direct investment.
   c. The third saw the lead pass from direct investment to bank funding liabilities, over the period from 1997 to 2008.
2. Looking forward, the era of massive bank funding inflows now appears to have come to an end, which leaves the economy once more confronting the age-old question of how the current account deficit is to be either funded, or covered by resource transfers into tradeables production. The fall in the New Zealand dollar exchange rate over the course of 2008 will have begun the transfer process, and the likely sharp drop in imports over coming months as recession bites will also help to bring the current account deficit down, as will the softening of the oil price, if and while it lasts. The immediate problem, however, is that the transmission of the economic downturn from the global economy to New Zealand will take place through the traditional channel of falling export earnings, not via the financial crisis, important as that is for domestic credit conditions.
3. As was the case in 1997, the economy in 2009 faces two alternative options to deal with a latent transfer problem: borrow or trade its way through. The borrowing route will be feasible only if some new group of overseas investors becomes willing to finance New Zealanders' living standards on a large scale. The government may, of course, embark on large-scale foreign currency borrowing to fund infrastructure investment (which will have a high import content if politicians persist with their desire to build large showcase projects near big cities, rather than the dispersed, small-scale, labour-intensive infrastructure construction that could make intensive use of New Zealand resources and contribute directly to living standards across the country as a whole).

So long as the massive inflow of offshore funding for the banks continued, and so long as that inflow continued to fully fund the current account deficit, the exchange rate was to some extent relieved of the downward pressure that would have accompanied and driven a large-scale resource transfer into tradeables production. The banks' private pursuit of profitable opportunities to expand local lending by borrowing offshore at relatively low interest rates has had significant spillover consequences for the macro economy since 2002, by holding the real exchange rate higher than would otherwise have been the case, weakening in the process the profitability of tradeables producers and hence reducing the economy's structural capacity to confront a transfer problem.

Because the expansion of lending had inflationary consequences domestically, driving up house prices and enabling non-tradeables suppliers to push their prices up without encountering stiff consumer resistance, it attracted a tightening monetary policy response from the Reserve Bank of New Zealand from 2003 to 2007 which widened the margin between offshore and domestic interest rates, setting up a positive-feedback loop which increased the head office pressure on local bank managers to lend more (subject to the obvious constraint that unwilling borrowers by definition do not have to borrow!).

Faced with the possibility of being unable to roll over maturing loans, the banks put pressure on the New Zealand government to copy its Australian counterpart and guarantee their offshore borrowing.

The events of 2008 have exposed the limits on the Australian banking system, and hence on its New Zealand subsidiary, and hence on the prospects for continuing to fund our standard of living by bank credit. The housing slump and the fall in equities values have stopped the 'hoover effect' as credit demand slows; while the credit crunch has stopped the force-feeding mechanism of credit supply in its tracks. The outlook is for bank balance sheets to deflate as the economy slows, with causality running both ways.

### The financial crisis

The vulnerability of the New Zealand banking system lies on the liability side of its collective balance sheet, which makes it quite different from the asset-side vulnerability of the banks in the United States and Europe. In the US, credit expansion was carried to extremely unsafe levels, with the result that a significant proportion of the banks' assets dropped in value as the housing market fell and defaults on mortgage loans spread. The resulting write-downs threatened the banks with actual insolvency, in the sense of having insufficient assets to meet all the claims of the banks' creditors.

The New Zealand (and Australian) banks in mid-2008 were well placed to cover all their existing liabilities, by liquidating assets if necessary, but with three vital qualifications:

1. *Exchange rate risk.* The liabilities had a far greater proportion denominated in foreign currencies than the assets, which meant that over time a falling exchange rate would progressively raise the New Zealand dollar value of a given volume of foreign currency liabilities.
2. *Exposure to a credit crunch.* In the event that offshore lenders became unwilling to make new loans to enable expiring loans to be rolled over, the funding for the banks' activities would be squeezed. The result would be illiquidity, not insolvency, so long as the assets of the banks (mainly loans to New Zealand residents) remain sound.
3. *Systemic risk related to the state of the real economy.* In the event that a very severe downturn in the New Zealand economy, and/or a crash of the housing market, were to force mortgage and other loans into default on a large scale, the assets side of the banks' balance sheets would weaken and the US scenario of the past year would become more relevant. On the whole there is adequate leeway in the condition of the 'typical' New Zealand households that are in debt to the banks (see Reserve Bank of New Zealand, 2008, p.20). More worrying is the high level of recent lending to agriculture (ibid., p.24), which has snowballed in the past six years to five times agriculture's value added, indicating that a significant segment of agriculture is very highly leveraged and so potentially seriously exposed to a world market downturn.

### The wholesale guarantee

Whereas in 2000 the inflow of non-resident funding was dominated by deposits lodged by the Australian parents with their New Zealand subsidiaries, over the subsequent eight years the parents ran up against a regulatory constraint (Prudential Standard APS 222) imposed by the Australian regulator, the APRA, which limited the exposure the Australian banks were permitted to take to offshore affiliates relative to the size of their Tier 1 capital at home. The banks had therefore increasingly turned to offshore markets for commercial paper, taking on large liabilities to third parties which could be rolled over only so long as the relevant offshore markets remained liquid.

As overseas financial markets seized up in September and October 2008, the banks' reliance on offshore funding became a looming issue. Faced with the possibility of being unable to roll over maturing loans, the banks put pressure on the New Zealand government to copy its Australian counterpart and guarantee their offshore borrowing. This involved a major change in fiscal strategy, which is in principle a matter for Parliament. The country was two weeks from a general election, with Parliament in recess. The minister of finance conceded that in the event of the guarantee being 'called' on a large scale, the contingent liability for the New

Zealand taxpayer could be $150 billion – ten times the size of the 'Cullen Fund' laboriously built up over the previous years of fiscal surplus. Even on a probability-weighted basis the exposure was huge relative to the established fiscal strategy approved by Parliament earlier in the year. In underwriting the banks' offshore borrowing, the New Zealand taxpayer would be in effect acting as an insurer/underwriter for risky private-sector financial transactions, in a setting where the usual protection a real insurer gains from diversity of risks was completely absent – in the event of a full-scale crisis offshore that brought the guarantee home to roost, it would be likely that several large guaranteed borrowers would go to the wall simultaneously. The privatisation of the country's external indebtedness that was a centrepiece of the early 1990s would be reversed at a stroke. Considering the likely state of overseas financial markets in the bad state of the world, the New Zealand government's own sovereign credit rating would probably count for relatively little, making the International Monetary Fund a potential lender of last resort.

The leader of the then Opposition came out strongly in favour of the guarantee, was briefly rebuffed by the then minister of finance, and the guarantee announcement was quietly slipped into place in the middle of the weekend of 1-2 November 2008. This was a dramatic change in the fiscal stance of the New Zealand government, undertaken without reference to Parliament and virtually without public debate on the important issues.

What arguments were there for the guarantee behind the scenes? Basically there appear to be five, none of them particularly compelling to my eye.

1. *The prospect of New Zealand dollar deposits over the $1 million ceiling of the retail guarantee moving to Australia required a response.* This is far from self-evident. The deposits leaving the New Zealand banks (and reducing the liabilities side of their balance sheets in the process) would only be going to Australia to be parked in the parent banks, from where they would necessarily have to return to the New Zealand economy, which is where New Zealand dollar-denominated assets live. Part of the assets of the New Zealand banks would thus have shifted, along with the liabilities, from the local branch banks to the Australian parents. In the process the corset imposed by APS222 would be relaxed. It is far from obvious that New Zealand business would have been less able to secure working capital from the Australian parent than from the New Zealand subsidiary, let alone that the problem would have been serious enough to justify putting taxpayers' money behind a guarantee.
2. *The banks would be better able to raise foreign currency loans* if they had a guarantee, which would mean that instead of issuing their own paper in New York or London, they would in effect be issuing government paper by proxy. Whether this is true or not I do not know, and I have seen no evidence to support the claim. The state of global financial markets in late October 2008 was such that very little paper of any sort could be sold. The eventual test of the argument for a guarantee will be the extent to which non-guaranteed bank paper is in fact able to be placed with offshore financiers. I am sceptical that the guarantee will have any measurable effect on the ability of the New Zealand banks to raise funds offshore. I am in no doubt, however, that the transfer of the risks of offshore funding onto the shoulders of the taxpayers – effectively socialising the risks of Australian bank shareholders at the expense of New Zealand taxpayers – amounts to a significant subsidy, legislated without reference to Parliament and implemented largely behind closed doors.
3. *The taxpayer stands to make money on the charges for the guarantee.* The guarantees certainly bear significant penal charges, but it is probable that there is asymmetric information at work. New Zealand officials may well be more sanguine about where the overseas financial markets are heading in the next two years than the banks' managements. Only after the event will we know whether a few billion dollars of fees is adequate compensation to taxpayers for the risk they are being obliged to bear.
4. *The government will emerge whole because of swap arrangements.* The issue here is that when the banks raised foreign currency funding for their New Zealand dollar lending, they entered into swap arrangements to place the foreign currency proceeds of their commercial paper issues with offshore borrowers for terms longer than 90 days. Paying off the foreign currency liabilities with New Zealand dollar funding would leave the corresponding longer-dated foreign currency assets orphaned, while unnecessarily driving down the New Zealand dollar exchange rate. If the government guarantee succeeds in reopening access to 90-day credit, the assets component of the swap deals can then be unwound over time, leaving all parties whole. This is a complex argument, but relies ultimately on proposition two above to give it any validity as justification for the guarantee.
5. *'Confidence' will be restored.* The difficulty is to know whose confidence exactly, what the determinants of confidence are, and indeed what confidence itself may be. Appreciative and supportive statements from the banks who are the beneficiaries of this piece of taxpayer largesse do not, it seems to me, suffice to provide good evidence

... where no rolling over of offshore funding was possible at all, the banks would be obliged to raise New Zealand dollar funding to pay down their foreign-currency debt.

that some relevant dimension of public psychology has been improved. Given the scale of the sums at stake, it would be good to have some substantial account of what this 'confidence' is, where it comes from, and exactly why it should be improved rather than scared by the sea change in fiscal strategy that has just happened.

Suppose that the wholesale guarantee had not been granted, or had been limited to New Zealand dollar funding only? In the worst case, where no rolling over of offshore funding was possible at all, the banks would be obliged to raise New Zealand dollar funding to pay down their foreign-currency debt. New Zealand dollar funding has been readily available from the Reserve Bank since May. The result would be a restructuring of the banks' balance sheets as their offshore debt was repatriated, accompanied presumably by a sharp depreciation of the exchange rate as the funds were transferred offshore. At the end of that process, more than half of the country's external debt would have disappeared and the current account would have moved most of the way back to balance, *ceteris paribus*.

Yes, there are downsides to this scenario, but none of them have been modelled and costed to my knowledge. Certainly they had not been modelled and costed at the point when the government and Opposition parties agreed to junk the prevailing fiscal strategy. The debate simply did not happen, so far as the public arena was concerned.

And yes, there are rigorous restrictions on the guarantee scheme that will undeniably reduce taxpayers' exposure very greatly; rather than $150 billion, we may be faced with a worst-case contingent liability of, say, $30 billion. That is still a lot of money, and it has been amazing to see how readily it was available to underwrite an offshore-owned banking system that was and is very far from insolvency and which is arguably perfectly capable of looking after itself in difficult times. Think of the amount of future fiscal leeway to undertake social policies to ameliorate a major recession that may have been made hostage to the financial sector, just as that very recession looms over the horizon.

1 Calculation from Table 3: ($138.9 billion – $21.7 billion) ÷ $159.2 billion = 74%.

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Brian Easton

# It's The Same This Time?

## Cycles and Depressions in New Zealand History

### Introduction

It is said that a banker's most dangerous expression is 'It's different this time', a phrase used to justify repeating actions which proved mistaken in the past. The economist's approach is a little different. Ideally, the same basic model should apply on all occasions. However, each time its application differs because:

- the parameters are different;
- the external shocks are different;
- the policy institutions (and therefore their reaction functions) are different.

As we face what may be the greatest financial crisis that New Zealand has ever experienced – albeit not necessarily the greatest economic crisis – we can try to use the experiences of the past to identify the underlying issues and the potential policy responses.

New Zealand has experienced cyclical economic downswings since it became a market economy 200 years ago. Not all are particularly well evaluated. Perforce, this paper confines itself to those for which there is sufficient scholarly work. I start with short-run cyclical fluctuations, then turn to the three major periods of long depression in New Zealand's post-1840 history.

### The standard postwar business cycle

The best studied short-run fluctuations are those of the postwar business cycle. Recent work by Viv Hall and John McDermott (2007 and forthcoming) identifies 11 cycles (excluding the current one), which implies an average length of about five years. Others, including myself (Easton, 1980, 1997), have identified up to perhaps another six smaller

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cycles, which would reduce the average to three years. So there is some disagreement about what constitutes a business fluctuation, and they are not very regular.

That means they are not simply the theoretical 'trade cycles' described in the seminal paper by Paul Samuelson (1939), which showed that under certain circumstances interaction between the orthodox consumption multiplier and the investment accelerator generates a regular sine wave.

The irregularity of New Zealand's business cycle tells us that while Samuelson's mechanisms may be important, the New Zealand business cycle is not based on a self-sustaining process but is likely to be a consequence of external shocks, as in the model identified by Ragnar Frisch (1933). The impression is that the mechanism is strongly damped: each shock generates a single fluctuation, with subsequent ones obscured by the next shock. The irregularity also tells us that the New Zealand business cycle cannot have been simply induced by an election cycle.

... the Long Depression of the 1880s and the Great Depression of the 1930s involved more complex processes under monetary arrangements which were different from the post-World War Two ones. There was then no central bank in New Zealand.

Nor are the fluctuations a regular sinusoid about a trend. Rather, the peak phase tends to be a growth plateau of four to twelve quarters, so it is difficult to identify a peak. The trough is much sharper – it can usually be identified to within a three-month period. This suggests that the characteristic shock induces a downturn, from which the economy recovers to running at its growth capacity until another shock ensues. This has some of the characteristics of the theory of the trade cycle proposed by John Hicks (1950).

Crucially, the business cycle and growth trend are not independent of one another, but are intimately linked. The longer the economy is on the growth plateau, the stronger the trend growth rate.

The best account of the cycle mechanism in New Zealand is still that of Eric Haywood and Colin Campbell (1976, 1978), written in the pre-1985 fixed-exchange-rate environment. The external shock which precipitated the typical business downswing was a fall-off in the price of exports (relative to import prices). The export sector suffered a loss of revenue, which caused both a reduction in spending (including on investment) and rising borrowing from the banks and other sources of finance. But the lending capacity of the banks was limited because they experienced a drain of foreign funds, as receipts from exports were lower than the outgoings for imports and debt servicing.

Because the exchange rate was fixed this deficit of foreign funds had to be covered by government offshore borrowing. The government, facing falling receipts itself, would reduce its spending, adding to the downward pressures from the export sector. Domestic sectors would face reductions in spending and so there would be a general contraction in production. At some stage these processes would reach a lower limit – as they do in the Samuelson and Hicks accounts of the business cycle – and the domestic upswing would begin, especially if there was a recovery in the terms of trade.

Here I make three modifications to the Haywood–Campbell analysis. First, there is an inventory cycle which is shorter, but of considerable amplitude, which exaggerates the underlying shock. Second, Schumpeterians would argue that the downswing was important in extinguishing less productive firms which survived during the boom. The released resources – labour and capital – would be transferred to more productive firms in the upswing.

The third caveat is more complex. Haywood and Campbell were writing before the floating exchange rate. Under the fixed-rate regime, banks facing a shortage of foreign funds obtained them from the Reserve Bank; hence the government's need to borrow foreign currencies. Today we have a floating exchange rate, and in principle the Reserve Bank need not borrow offshore.

How the economy fluctuates under a floating exchange rate has not been properly evaluated; the long Rogernomics recession involved some other events which complicate the analysis, and the fact that the Australian economy sailed through the Asian crisis while the New Zealand economy did not suggests that policy makers got it wrong. (The downswing, troughing in the first quarter of 1998, involved an unfortunate monetary policy response guided by a monetary conditions index which was mathematically wrong, without theoretical foundation and empirically untested.)

In summary, the postwar business cycles all display the same internal economic mechanisms, although the external shocks may have differed, and different policy mistakes may have been made. But monetary phenomena were endogenous – albeit in different ways reflecting different institutional arrangements – both before and after the floating of the exchange rate. This endogeneity of money was not true for the two major downswings New Zealand experienced before the war.

### The Long Depression of the 1880s

There were short-run fluctuations throughout the 19th and early 20th century. Some were externally generated, as in the late 1840s when Māori were left stranded with provisions for ships which did not arrive because of a financial crisis in Britain. Some were home-generated downturns which occurred when temporary unsustainable activities ran out of resources – the whale or alluvial gold quarries – or a boom from war or borrowing came to an end, or when settlements ran out of their initial capital for investment.

However, the Long Depression of the 1880s and the Great Depression of the 1930s involved more complex processes under monetary arrangements which were different from the post-World War Two ones. There was then no central bank in New Zealand. Rather, the trading banks held sterling reserves. A run-down of these balances (as when export revenue fell relative to import revenue) led the banks to contract domestic lending. New Zealand was on a 'sterling' standard, not a gold standard.

In October 1878 the City of Glasgow Bank failed with a capital deficiency, for its liabilities of £12.4m were covered by only £7.2m of assets. There had been deliberate falsification in the accounts, and all the directors were jailed. There being unlimited liability, about 1,000 shareholders were ruined. (What must have been exceptionally galling was that so skilful were the deceptions that on the last day £100 shares were trading at £236.)

New Zealand was affected in two ways. First, the bank had made speculative investments in Australia and New Zealand, in the hope of recouping banking losses. Second, and following three further bank collapses in December, there was a tightening in the London money market. New Zealand had spent the previous decade relying on borrowing in London to support the Vogel boom. The tap was turned off and there was a credit contraction. Trading bank advances, which had almost trebled between 1870 and 1879, fell 15% in the following year, and while there was some subsequent growth, New Zealand struggled through the next decade in 'The Long Depression'.

There are two other elements crucial to this story. First, wool prices fell. Although they had been falling since 1873, the further fall of a third between 1878 and 1886 reduced the banks' sterling receipts and the income of farmers (and of those whom they purchased from). So, while the Long Depression was precipitated by a monetary crisis overseas, the independent terms of trade deterioration compounded the misery.

Second, there had been land speculation in the 1870s, including irresponsible lending by banks (as the City of Glasgow Bank story suggests) but also fueled by the government borrowing of the Vogel era. As a result, land prices were out of line with the returns from farming the land. As a bank inspector (W.G. Rhind) commented about Hawkes Bay, the land prices were 'enormous' and fictitious', and 'most monstrous' payments were being made, thanks to settlers holding 'the most sanguine, not to say wild ideas of the importance of the place' (Sinclair and Mandle, 1961, p.101).

Owners were thus saddled with excessive interest payments on overvalued land. Banks were faced with the dilemma of carrying such owners, or bankrupting them and taking over the land, possibly unable to onsell it, and probably having difficulty maintaining its productive value without a committed farmer. Some banks later failed. But because they were a peripheral part of the London banking system there was no great financial shock, although the New Zealand government bailed them out.

Factor and product prices were flexible in those days, and there was a general lowering of price levels. However, debts are usually set in fixed nominal terms, and so are inflexible. One of the greatest problems in each depression has been how to realign debts with actual prices; sometimes bankruptcy is the only option.

### The Great Depression of the 1930s

The toxic combination of international monetary turmoil, slumping export prices and excessive domestic debt levels was repeated in the Great Depression of the 1930s. This time the monetary crisis almost certainly contributed to depressing the terms of trade.

My analysis suggests that the Great Depression was in fact part of a longer Interwar Depression, but I won't pursue that here. Certainly, the debt problem was prior, for farm land prices were too high. In the 1922–29 period the return on farmer equity averaged 3.4% per annum, whereas they were paying 6.5% per annum on farm mortgages; retirement would have given them better return. Future productivity and prices lifting incomes might have changed the balance. Such optimism proved illusory. In the four years after March 1930, the returns on farming did not even cover the value of the labour of the typical farmer, let alone give a return on the capital.

The fall in farm output prices (even relative to input prices) was caused by the world economic crisis which had been precipitated by the 1929 Wall Street crash. (It is now generally accepted that the causes of the crisis were more complex than the crash by itself.) It is harder to stop farm production than factory production – harder to lay off livestock than the workforce – so there tends to be an oversupply of farm products relative to manufactures, which drives down their relative price. With land prices – or, more accurately, the farm debt secured on land – already too high, the fall in output prices was a recipe for disaster.

The government position was not wholly robust either. During the 1928 election campaign, Joseph Ward promised to borrow £70m. He probably intended to do so over ten years, and so was nominating a rate not unlike that of the previous decade. The borrowed funds were used for the works programme. When the money dried up, the programmes were cut and workers laid off.

With land prices – or, more accurately, the farm debt secured on land – already too high, the fall in output prices was a recipe for disaster.

Government borrowings in the London financial market were first deposited with the Bank of New Zealand (the trading bank the government partly owned), and became part of its sterling balances. The money used in New Zealand, which ended up in one of the other five trading banks, would be transferred to their London sterling balances. Funds used to purchase imports would end up in a foreign trading bank, reducing the aggregate sterling balances in London. Thus the government's sterling loan would be run down, initially to other New Zealand banks, later to those outside the New Zealand system.

Similarly, export receipts would end up in one of the local bank's London accounts, be transferred to other banks' accounts as the exporter spent the money in New Zealand, and drain away as the money was outlaid on imports.

The permanent price collapse [of wool and sheep meat] meant that much of the capital value in the industry had to be written off. The downswing proved longer than usual, which inhibited physical investment and innovation.

So long as banks had a surplus of sterling balances they could make advances to New Zealanders, knowing that the surplus would be drained to other New Zealand banks and, eventually, outside them. If there were no additional funds coming in from government loans, and if export receipts fell (as they did by over a third between 1929 and 1931, from £55m to £35m in the year), the banks would have to contract their advances.

On top of the reduction of expenditure because farmers had less income, there was a reduction in funds for investment (including on public works), while trade credit was harder to obtain. The same economic mechanisms which we later see in the postwar business cycle generated an economic downswing. The fall from the peak in the year ended March 1930 to the trough in 1934 amounted to around 12% in real GDP terms (and more than double that relative to the trend growth).

It is common to criticise the policies of the government of the early 1930s. Perhaps they were not fair, failing to share the burden of adjustment equally. The social hardship they caused is well recorded; the worst hardship was from unemployment. Some of the criticisms are extravagant. It is true that wages were cut by government fiat, but they followed prices down and real wages were broadly maintained.

The government did not pursue expansionary measures, for without sufficient control over the monetary system it could not practice macroeconomic management. Indeed, it had so little influence that the foreign reserves (sterling balances) of the trading banks rose between 1930 and 1935. Unlocking the reserves for public policy purposes required a central bank.

New Zealand had entered the Depression with excessive debt, and the fall in both export and import prices disrupted the relationship between external and internal prices. Much of the policy activity of the period was to regain the balances between debt and domestic prices and within the price system. The devaluation of the exchange rate, the cutting of wages, the Mortgagors and Tenants Relief acts all had this purpose. This realignment, plus new policy institutions such as the Reserve Bank, provided the foundation of the expansion for which the subsequent Labour government is renowned.

This realignment of nominal price relativities is central to a sustainable Keynesian expansion. The conventional account of New Zealand in the Great Depression is based on a simple model in which a single commodity can be expanded and contracted by demand management. However, an open economy must have multiple commodities, for otherwise it would not be necessary to export and import. A critical part of the story of the Great Depression involves a multi-sectoral analysis which includes the relative prices between sectors and the debt they carry. Fortunately the economist advisers of the 1930s grappled with it.

#### The third depression, 1966–93

Describing the period from 1966 to 1993 as a 'depression' may seem artificial. It certainly was a period of high unemployment, and poor economic performance. What distinguishes it from the earlier depressions is that the world economy prospered, so New Zealand grew more slowly than it generally did. It may be better to describe it as a period of slower economic growth – even a climacteric or retardation in the trend of economic growth – or a structural adjustment response to a new world situation (poorer prices for New Zealand's key exports). It is included here because some commentators have compared the period – especially the long (Rogernomics) recession of 1986 to 1993 – to the current economic situation. This depression began with the fall in the auction price of wool in December 1966. It was a structural change – except for the 1971–72 world commodity boom, the relative wool price never recovered. The price shock came not from some international monetary crisis but was particular to the industry: competition from synthetics.

As about two fifths of export receipts in the 1960s came from wool, a structural price fall of around 40% meant a 16% loss of export receipts. It was actually worse than that, because in 1966 another 20% of receipts came from sheep meats, so the sector that dominated exports was devastated. (Today, sheep meats contribute about 15% of the receipts from the exports of goods and services, with wool providing a further 5%.)

> Foreign borrowing fueled a speculative financial bubble which burst in October 1987 when the world's share markets collapsed. This was a financial rather than a monetary crisis, and New Zealand's monetary system was not seriously compromised.

The permanent price collapse meant that much of the capital value in the industry had to be written off. The downswing proved longer than usual, which inhibited physical investment and innovation. As the rest of the world economy prospered, New Zealand's stagnated, and so it declined in the world rankings of income per head. Over the decade after 1966 the New Zealand GDI per capita fell about 15% relative to the rest of the OECD. Following the downswing of the later 1960s there was a temporary recovery from the world commodity boom in 1971–72, which switched over into the sharp downswing of the 1973–74 oil shock; New Zealand followed. The economy was weak in the late 1970s and unemployment more apparent.

While the standard economic mechanisms of all the early postwar downswings occurred, the structural price collapse in the economy's leading sector triggered a major long-term restructuring of New Zealand's external economy. By the end of the 1970s it had moved from being one of the most concentrated exporters, by both product and destination, to the middle of the OECD pack. However, the domestic restructuring was slower. The available economic analysis was only of limited help, because it was trapped in a single commodity model. (That epitome of conventional wisdom, the New Zealand Planning Council, appears to have never grasped the significance of the terms of trade.) Instead, the question of who was to bear the burden of the deficit was resolved by ongoing inflation, which allowed each group in the economy to shift the burden temporarily elsewhere. Ultimately it was the fixed interest investors who suffered.

The dominant politician of the day, Robert Muldoon, his childhood scarred by the Great Depression and naturally conservative, found it politically easier to protect weak industries than to have their workers redeployed into more productive enterprises.

So, for over two decades there were two largely unanswered questions:

- How was the reduction in effective incomes to be shared among the different parts of the economy?
- How were the domestic labour and other resources to be redeployed (noting that the diversification muddied the distinction between the external economy and domestic economy which had previously existed)?

Growth was stronger in the early 1980s (partly as a result of the 'Think Big' major projects, which proved less valuable than expected when oil prices fell in the mid-1980s). Then the 'Rogernomics' policy regime of almost unconstrained market liberalisation heralded a 'long recession' from 1987 to 1993.

The new regime addressed the outstanding questions. In the process of quenching inflation it reduced real benefits, and wages at the lower end of the pay spectrum. Workers locked up in the protected firms were dumped onto the labour market. In the three and three-quarter years from 1988 the equivalent of 43% of the labour force registered with the Department of Labour as unemployed (multiple registrations not included).

While the changes involved some fundamental modifications to employment and government spending arrangements, monetary arrangements were central. Following the floating of the New Zealand dollar in March 1985, the trading banks purchased their foreign currency directly on the market rather than from the Reserve Bank as had been the rule in the fixed exchange rate regime. The exchange rate varied depending on the supply and demand for currencies and the expectations of their future. Export profitability is the inverse of the (real) exchange rate, so a high rate means low export returns, especially following the withdrawal of subsidies. As the government allowed the real exchange rate to rise following the 1984 devaluation, export growth slowed down. The New Zealand economy downsized, with per capita GDP falling in each of six years, costing another 15% of per capita gross national income relative to the OECD.

In the floating regime, borrowing was an individual matter and its wider implications were ignored. There was, for example, no certainty that the exchange rate would support the export sector sufficiently to ensure that the economy could grow. The consequences for the export sector were evident as early as 1985. A high exchange rate was central to the anti-inflation strategy, since the cheaper imports pressed down on import-competing sectors – most of which closed down – while raising real wages without raising nominal wages, for those who still had jobs.

Foreign borrowing fueled a speculative financial bubble which burst in October 1987 when the world's share markets collapsed. This was a financial rather than a monetary crisis, and New Zealand's monetary system was not seriously compromised. However, the local share market failed to recover with any of the vigour of its counterparts, demonstrating that it was artificially stimulated by the market liberalisation and the easy borrowing. There was no underlying strength or robustness in an economy whose tradeable sector was being undermined by the same high exchange rate which was a result of the capital inflows which fueled the speculation.

In summary, then, New Zealand's third depression was a response to price misalignment, initially from the collapse in the wool price, but subsequently from an overvalued exchange rate. Debt was a problem in so far as it reflected outdated price relativities, but except in the 1986–87 financial boom and bust it was not a major factor. It is hard to blame the rest of the world for New Zealand's difficulties in this case; local policy responses certainly exacerbated them.

### Is it the same this time?

Table 1 compares the three substantial depressions which New Zealand has faced.

**Table 1: Depressions in New Zealand**

| | The Long Depression 1878–mid-1890s | The Great Depression 1929–35 | The Third Depression 1966–93 |
|---|---|---|---|
| International monetary crisis? | Yes | Yes | Not really |
| International economic crisis? | Subsequently | Subsequently | No |
| Terms of trade | Fell, some recovery | Fell and recovered | Fell |
| Domestic price alignment | Probably not serious | Major measures to deal with it | Real exchange rate overvalued |
| Debt problem? | Farm debt too high; excessive government borrowing | Farm debt too high; excessive government borrowing | Not a serious problem, except during 1986–87 financial speculation |
| | | | |
| | | | |
| Economic management | Hardly existed, fiscal stringency | Good, but limited by institutions | Poor |

This paper's aim has been to identify the key elements which contributed to previous New Zealand depressions. It turns out that while many of the economic mechanisms were the same, there were differences in external circumstances, terms of trade, debt and economic management. Closer inspection suggests that the first two depressions were similar, but the third was different. It is included here because its institutional arrangements are closer to today's circumstances and because it is more prominent in the popular memory.

How do those previous experiences compare with what we are now heading into?

#### *External circumstances*

There is no doubt that the world is facing a monetary crisis, and it is probably optimistic to assume it will be soon over, for there are almost certainly consequential collaterals that have yet to work their way through. Arguably, the world is better placed to deal with the crisis than on previous occasions; arguably, this crisis is more widespread and complex than on previous occasions.

The world economy has entered a recession. The late 2008 central forecasts suggested the world recovery will begin by early 2010. That may be optimistic. Nor can we rule out the that possibility the subsequent expansion will be weak in output terms or highly inflationary, or perhaps different in ways we cannot anticipate.

***Price alignments***

There has been some falling off in commodity terms of trade from recent high levels. Some of the falls, such as for oil, are of benefit to New Zealand. There is no reason to believe that the current export price trends are a detrimental structural change like they were in 1966 (except that we might expect energy prices to rise). There is reason to believe that the food price terms of trade may be secularly rising.

Assessment of the domestic price structure is complicated by the real exchange rate, which undergoes medium-term cycles under the current macroeconomic policy framework. The rise in the 2000s choked off export growth and tipped the New Zealand economy into a growth slowdown – even a recession – before the world recession started. There has been a subsequent fall in the exchange rate, in part as the cycle enters the next phase, but probably also because of capital flow responses as a result of the world monetary crisis. The exchange rate is near the middle of its 'normal' range whereas recently it was at the top. It seems likely to fall further as the cycle continues.

We do not know how quickly the export sector will respond to this more favourable exchange rate. It almost certainly faces a reduction in world demand, which will affect different sectors quite differently.

The fall in the exchange rate suggests that there may be upward movements of domestic prices, although these may be moderated by the fall in world commodity prices.

***Debt***

By the standards of previous depressions the government and the business sectors appear to have favourable debt levels. However, the household sector is holding unusually high debt by past standards. This is largely secured against over-priced housing, although there is some consumer debt with little security. It is almost all owed to banks. In so far as it will be protected by the Reserve Bank, the private sector debt becomes a public sector problem.

While most consumer debt is legally secured against housing, it is largely serviced from labour earnings. As long as unemployment remains low the housing debt problem is manageable for most individuals, although there are some who are over-borrowed against their human capital. The challenge will be at the macro level: can New Zealand roll over its international debt at reasonable cost?

Mention has to be made of the non-bank financial sector. It would appear that much of it was over-borrowed, invested in schemes which would never give an adequate return except on implausible assumptions of capital gains. Much of that has been wiped out with defaults, but the offset is that many households have lost substantial deposits and are the poorer.

***Government macro-economic management***

Its current quality is too soon to tell.

## Conclusion

Table 2 puts the previous sections' discussions in the context of Table 1.

**Table 2: Depressions in New Zealand**

| Depression | Long | Great | Third | This one? 2008- |
|---|---|---|---|---|
| International monetary crisis? | Yes | Yes | No | Yes |
| International financial crisis? | Yes | Yes | Minor | Yes |
| Terms of trade | Fell, some recovery | Fell, some recovery | Fell | Probably not a long-term problem |
| Domestic price alignment | Not serious? | Major measures | Exchange rate | Exchange rate |
| Debt problem | Farm debt, public debt | Farm debt, public debt | Financial speculation | Household, overseas |
| Economic management | Hardly existed | Good | Much poor | ? |

In conclusion: yes, this time it is the same; yes, this time it is different.

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Robert Stephens

# Social Policy, Cold Climates and Economic Recessions

*Prediction is extremely difficult when it is about the future*

ancient Chinese proverb

### Introduction

The aim of this article is to consider what *could* happen to social policy expenditure and parameters in a worst case scenario, if the financial crisis spills over into the goods and services sector. Academics are very good at making *ex post* analyses of why certain events occurred, and extrapolating from this past experience to predict the future, but the future will be different. The starting point will not be the same – people have learnt from the past and have different reactions, the context will vary, and the political players and ideology will have changed. The policy adviser has to be forward thinking, anticipating events. It is in this context that this article is written.

Expenditure on social policy (working-age benefits, pensions, health, education, housing, ACC) accounts for roughly 70% of government expenditure, and is largely financed from general tax revenue. As a consequence, any planned changes in total government spending or tax take are likely to have an impact on the social policy area.

This discussion is set in the post-November 2008 political context of a predominantly National-led government, supported on the (far) right by ACT, and on the left (predominantly) by the Māori Party. The paper concentrates on what *could* happen to social policy, given this political configuration, and varying degrees of recession. The article is thus speculative, and certainly not intended as a blueprint for change.

### The context for social policy developments

The options for social policy do not fall into a simple public/private dichotomy, because of the not-for-profit sector, which delivers a wide range of social services under varying types and degrees of cont,acts with government, as well as its own funding. A distinction can also be drawn between funding, provision and decision.

- *Funding* could come from any mix of direct public revenue, user charges and charity/donations.
- *Provision* could be a mix of public, not-for-profit and/or private organisations.
- *Decision* relates to who chooses the quantity and quality of services to be provided, though private decisions may be subject to government regulatory changes.

For instance, not-for-profit organisations could provide services, be financed and contracted by government for specified outputs, or be allowed to choose their own mix of outputs, financed by user charges. Or certain services, such as early childhood education, could be provided by for-profit organisations financed by government-provided supplementable vouchers, with service delivery decisions regulated by government. Each of these parameters, and their mix, could change in a new environment.

In the short term, much social policy spending is demand-driven. The drivers are population age and structure, and trends in numbers entitled to service delivery. The current

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conjuncture for social policy is an ageing population, with the baby boomers hitting pension age from 2010, although the major impact comes a decade or more later. Partly counteracting this, there was a blip in births in the 1990s, and these people will enter the labour market and tertiary education about 2010.[1]

The affordability of the current policy settings is significantly affected by both the proportion of these baby-blippers going into tertiary education and the labour market success of this group. The baby-blippers will have a higher proportion of Māori and Pacific people, whose average labour market skill levels are below those of the population as a whole, with that lower skill level potentially reducing economic growth. As the majority of the elderly population is white, there is a potential for ethnic tension, especially if the current differentials in employment rates, benefit receipts, poverty rates and income distribution are maintained.

Compounding these demographic, demand-driven pressures is the current rise in the number of births. These children will reach pre-school age around 2010 and primary school a couple of years later. To maintain current staff–student ratios in primary school, at least a further 560 classrooms will need to be built, along with a similar number of teachers trained.

In the short term these demographic effects may be a more important driver of social spending than the recession. However, they are likely to increase the imperative on a National-led government to control expenditure growth, even if there was no recession. The National Party made a large number of 2008 election manifesto promises that will increase government expenditure and reduce tax take if implemented, while keeping most of the Labour government's enacted social policy changes. The distrust that the 1991 benefit cuts engendered will reduce the initial willingness of National to move significantly from their manifesto position.

#### Recessions and cold climates

Scenarios differ about the extent of the recession, with the range going from short and mild through to global and severe economic meltdown. For the purpose of this analysis, all that is needed is three alternative scenarios, for each of which one may take a crystal ball and guess at the changing political strengths and ideologies within a coalition government to see a possible social policy impact.

The economic scenarios are:

- a mild recession, of short duration, leading to unemployment of up to 5%;
- a moderate recession, but lasting up to five years, with minimal economic growth and higher unemployment of longer duration; and
- a global depression, with unemployment rising to 15% or more and widespread closures of businesses.

'Cold climates' refers to the attitudes that those in political power take towards the welfare state. Successive Labour-led administrations had developed a Third Way approach, based on social development and social investment supported by integrated and co-ordinated policy development across social policy agencies to address complex social problems.

... the return to the 20th century's approach to welfare policy, which has been shown by several Ministry of Social Development evaluations on the community wage scheme to have had no significant beneficial impact on long-term employment outcomes

A social development framework was initiated because many of those on social security benefits were there not because of being work-shy or facing adverse labour market conditions, but due to a range of other social conditions – domestic violence, psychiatric conditions, substance abuse, absence of labour market skills, or physical disability. The source of these problems needed to be addressed first through social investment from a range of service delivery agencies, before individuals were enabled to enter the workforce. Nevertheless, the policy was 'work first', to provide a long-term solution to poverty through a mix of both incentives through the in work benefit and the use of case management to direct beneficiaries into work, training or caring streams. The aim was to reduce the social problems that stem from poverty, rather than using the benefit system as a short-term palliative.

The National Party's election manifesto specifically rejected this social development approach, advocating a return to 'welfare'. This change in philosophy is designed to ensure that beneficiaries will receive the existing 'safety net' level of benefits, but will fail to address the reasons why people are on benefits in the first place. The 'work first' approach will remain, but by forcing people into quasi-work via a 'work-for-the-dole' or 'community wage' scheme and requiring them to accept any job offer that comes along. My concern is to highlight the return to the 20th century's approach to welfare policy, which has been shown by several Ministry of Social Development evaluations on the community wage scheme to have had no significant beneficial impact on long-term employment outcomes.

#### Scenario 1: a mild recession

Here the expected 'climate change' is that of a chilly day, not a roaring Wellington southerly. The economic recession is mild, and of relatively short duration, successfully addressed by Keynesian stimulatory fiscal policy combined with monetary policy of lower interest rates and bank guarantees. Current policy settings and expectations from Treasury in their pre-election fiscal and economic update forecasts seem to be based on that scenario, though there is increasing recognition that the clouds in the south are a portent of deteriorating conditions, as shown in budget economic forecast update. Even with the Ministry of Social Development's more pessimistic forecasts, economic growth reappears late in 2010, resulting in some, but not large, increases in numbers on each of the working age benefits. The biggest impact would be on second- and third-tier benefits such as the accommodation supplement, special needs grants and temporary additional support. Expenditure on health and education would probably be maintained.

In the mild recession case the National Party can probably maintain its policy manifesto, though with frost causing some fraying around the edges due to the combined impact of the Māori Party and ACT. Both ACT and the Māori Party want a reduced role for government in social policy, but for different reasons. Māori want, for their own people, service provision and delivery to be devolved to hapu or iwi, so that services can be provided in a culturally appropriate way, although funding will still be from central government. ACT also wants to minimise the role and functions of government, but by devolving spending decisions to individuals, from their own pockets or through private insurance. An initial ACT move may be for government-financed vouchers that can be supplemented by individual contributions, to enable choice in private sector service provision. An alliance between ACT and the Māori Party may result in greater devolution of social service delivery.

... with a mild recession the bulk of the current welfare state is likely to remain intact, but with greater reliance on user charges and vouchers, some privatisation to insurance companies, and a return to a work-for-the-dole scheme.

There are strong indications of greater user pays, largely from not increasing or indexing existing social policy programmes, as well as increasing private provision. With early childhood education, while National is committed to maintaining existing subsidy levels, the 'free' aspect will be removed and greater flexibility for private providers introduced, with the latter able to obtain the fee subsidy. In tertiary education, cuts in funding are likely, as the student fee cap will remain, but the government will not increase funding to the universities, with an impact on teaching and research quality.

National has already signed up for the Working for Families package's indexation of benefit levels by the CPI (though there is an ominous sign that similar indexation will be used for New Zealand Superannuation despite the government accepting the current level at 66% of average earnings). Both the New Zealand Super Fund and KiwiSaver will be kept. There will be major changes to the direction of investment of the fund into infrastructure, where the return on investment will be problematic, reducing the ability to keep current tax arrangements for future funding of New Zealand Superannuation, exacerbated by using the fund to finance the expected budget deficit. Altering the required level of individual savings and employer contributions to KiwiSaver could lower savings (and investment), and future standards of living for tomorrow's elderly.

There are some positive proposed improvements. Included in these are a slight easing of the threshold before benefit abatement starts, extending the in-work benefit, and maintaining the maximum accommodation supplement for those who become unemployed as a result of redundancy for 16 weeks. However, these policies may fundamentally change the nature of benefit provision. There will now be two tiers of benefits, with more going to those made redundant for 16 weeks than to other unemployed, or people on other benefits. Employers may be more willing to make workers redundant, or to reduce redundancy payments, knowing that the state will pick up some of the expense. This will be similar to an earnings-related benefit, where past standard of living is a determinant of benefit level, rather than need. It would be a shorter step to a social insurance model, which is a form of user pays, with a safety net social assistance scheme underpinning it.

Other policy announcements will make a more fundamental difference to the nature of the welfare state, and the presence of ACT in government is likely to accelerate changes towards greater private insurance in both health care and accident compensation. In health, the plan is to make greater use of public–private partnerships, especially for elective surgery, in order to reduce waiting lists. Unless there is a significant increase in the size of the medical profession (the supposed efficiency gains are usually illusory), all that this two-tier medical system will do is transfer resources from the public to the private health system, resulting in rationing by ability to pay rather than by severity of medical condition and waiting lists. Private health insurance will be too costly for the elderly (due to experience-rated premiums) and for most on low incomes, leading to the public hospitals becoming residual providers.

Although there has been limited detail concerning National's policies on ACC, already funded on a social insurance basis, there is no doubt that they plan to privatise at least some of the seven ACC accounts, a return to the brief 1999 experience. The most likely to be privatised are the employer and self-employed accounts, though the motor vehicle account could also be covered. This is despite a PricewaterhouseCoopers report that said 'there is a moderately strong view that government monopoly is the best mechanism for operating the employer account', and Blue Lotus research showing that private insurers were more reluctant to approve claims, were late in paying, and placed pressure on employees not to lodge claims. The employers account is only 12% of ACC revenue, so ACC direct savings will be relatively small, with the cost falling on employees and profits going to Australian-owned insurance companies.

Thus, with a mild recession the bulk of the current welfare state is likely to remain intact, but with greater reliance on user charges and vouchers, some privatisation to insurance companies, and a return to a work-for-the-dole scheme. The policies are those of the last century, based on a philosophy of 'welfare' or passive payment of benefits combined with an enforcement of work, rather than an approach that attempts to enable people to achieve their potential. Devolution of social policy delivery to not-for-profit organisations under contract to the government may also occur, depending upon a confluence of pressures from ACT and the Māori Party. The adverse changes will be made stealthily and gradually, in order to avoid a political backlash, and tied in with 'good news' announcements.

Student fees will rise as a proportion of a declining funding from government to tertiary institutions, and student loans will return to market interest rates with shorter repayment periods.

**Scenario 2: a moderate-to-severe recession of long duration**

Because of the relatively severe and long duration of the recession, this scenario looks at a political situation in a second term, where ACT, with a clear political objective, will have a greater policy influence, with the Māori party sidelined.[2] The simplest case here is for the existing policy direction to continue, but more so. However, a move to a flatter tax system, with lower tax rates, is likely to significantly lower tax revenue, and lead to a vigorous call for government expenditure cuts in order to avoid a growing budget deficit. In both 1984 and 1999 a less severe fiscal and economic crisis was used to introduce radical change to the prior policy parameters, and the same could all too easily happen again. Keynesian economics may be foregone for monetarist and new-classical economic policy prescriptions.

The speculation here is that there will be cuts to most programmes through: financially-constrained or targeted vouchers; reliance upon market provision; privatisation of social services; increasing degree of user pays; devolution to not-for-profit providers and iwi/hapu, where contracts will be financially tight, requiring donations or charitable support if existing services are to be provided; local government severely restricted to provision of local services; and even tighter targeting on the basis of need for the residual government provision. The welfare state will become truly residual, providing a bare minimum safety net, with many in even low-paid employment effectively targeted out of government provision. The incidence and severity of poverty will rise, living standards will fall, especially over a period as assets are run down, inequality will rise, and inter-generational transference of a lack of social inheritance will have an impact on social and economic development for decades.

There is a range of feasible policies that could come in, with their desirability depending on the ideological perspective of the reader. Some of these have been listed above, but others, like the largest ticket item, New Zealand Superannuation, will come under increased scrutiny.[3] There are several options for Super. First, the age of eligibility could be raised to 68 or above. Initially there may be a two-tier system, with a lower pension level for those retiring at 65, but eventually the ages and rates will converge at the lower pension level. Second, the pension level may itself be lowered, maybe to the invalids benefit rate, or more slowly by adjusting the rate with consumer prices rather than average earnings. Third, pensions could be targeted through the use of a surcharge, or other targeting mechanism such as asset testing, though, as in the past, the interaction of the surcharge with occupational pension and investment income will result in significant avoidance behaviour.

Working-age benefits may not always receive cost of living adjustments, or may all be reduced to the unemployment benefit rate, reducing even further their real value. Stricter entitlement rules may appear, cutting the number of people eligible, possibly using past contributions to the tax base through work. Longer stand-down periods may be introduced. An alternative may be a shift to social insurance, and, even though the OECD regards social insurance contributions as a form of tax, they will be off-budget and seen as a form of privatisation of income maintenance.

Student fees will rise as a proportion of a declining funding from government to tertiary institutions, and student loans will return to market interest rates with shorter repayment periods. Vouchers for compulsory education, able to be supplemented with private contributions, will be reintroduced on the basis of parent/child choice, but in essence the better schools will be able to choose their students based on academic record and level of contribution (again a two-tier system). The voucher system may also apply at the pre-school level, with care of children for working parents replacing early childhood education, with the aims of offsetting social inheritance and raising long-term educational standards put into abeyance.

Greater reliance upon health insurance, the removal of subsidies for GPs, and full costing of diagnostic testing are other possibilities. These would switch health expenditure from the government to the private sector, with the higher-health-risk individuals who are less able to afford health insurance facing a residual, poorly funded health system. A return to market rents may have happened under the first scenario, along with an initial sale of state housing. That sale may become complete, with the poor left dependent upon a limited stock of social housing or sub-standard dwellings.

The scenario painted here is dramatic and likely to cause significant hardship and inequality, and potentially social upheaval. The policies described here would eventually ensure a change of government, but while a new, more liberal regime would then be in office, there would be a short-term lack of room to manoeuvre because of the parlous state of the economy and the government's fiscal balance constraints. Only a gradual change could be contemplated.

**Scenario 3: a severe recession of long-term duration**

This scenario is only likely to occur if the crisis is truly global. New Zealand, with its agricultural base and plentiful water supply, may be better placed to maintain a minimal standard of living compared to many other countries. The impact of a global recession coupled with possible impacts of global climate change may result in inward migration, especially from the Pacific Islands.

In terms of social policy, the changes above would probably be as bad as it might get. Under truly extreme circumstances 'all bets are off'. The climate may be a howling Wellington southerly with horizontal rain, but it might lead to a warmer, more compassionate society, as occurred with the 1938 Social Security Act, depending upon political configurations. A New Right government may effectively abandon the welfare state; a left-of-centre government could try to restore the welfare state, albeit at a lower level of service provision.

From a social democratic perspective, let us hope that none of the above scenarios applies. But most of scenario one is already in train, and may be hard to prevent. The second scenario indicates the imperative of quickly addressing the current financial crisis, and preventing it turning into a more serious crisis in the goods sector. With a mild, or even moderate, crisis there is much that a government could do in a positive light to ensure that New Zealand was in a strong position to take advantage of the technological age, through retraining to offset an adverse social inheritance. The downturn may represent an opportunity as well as a threat.

1 The previous baby-blip entered the labour market and tertiary education in 1988–92, when the economy was also in recession. It took many of those affected a long time to obtain employment and has been a probable cause of inter-generational transmission of adverse outcomes.
2 Under this scenario, the National Party may be less able to form a majority without help from several other parties, or even remain in power. A return to a Labour-led administration would see many of the above policies reversed, as in 1999, but the fiscal constraints would probably limit any significant changes to the above policy settings, though Labour would not venture down the route speculated in this current scenario.
3 Winston Peters will not be in Parliament, so the influence of Grey Power on policy will be less, but the ageing of the population will make them a significant voting block which a government will upset at its peril.

Michael Fletcher

# Social Policies in the Recession[1]

**Introduction**

While we cannot prevent many of the current recession's impacts, there are real social policy choices open to policy makers – choices that can reduce its severity, influence who bears what costs, and, importantly, have an impact on the longer-term, post-recession outcomes. How well New Zealand performs economically and socially in the years after the current recession is over will depend in part on how well we manage the distributional consequences of the recession and on the social policies implemented during the recession.

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In the last significant downturn, from 1988 to 1993,[2] New Zealand did poorly in terms of social policies and social outcomes. The result was that on some indicators, for some groups and in some communities the consequences of that recession lasted well into this decade. Associated with this has been an economic cost in terms of higher social expenditures and lower productivity. It may be that the current recession will not be as prolonged or as severe as that of the late 1980s–early 1990s, but it is looking increasingly likely that it will be. At the time of writing the Reserve Bank is forecasting unemployment to peak at about 6%; other commentators are suggesting that the figure could be nearly 9% and many are talking of a long, 'L-shaped' recession with a slow recovery.

In this paper I review a number of key social indicators as a way of assessing our social 'starting point' in comparison to the late 1980s. I then suggest some priorities and principles for social policies through the recession, before very briefly commenting on three key policy areas.

### Where are we starting from?

#### *Employment and unemployment*

The employment rate – the percentage of the working age population that is in work – is currently higher than at any point since the Household Labour Force Survey began in 1986 (see Table 1). There are, however, significant differences between sub-groups of the population. In particular, the long trend towards convergence between male and female employment rates means that the female employment rate, at 60.1%, is now significantly higher than in 1987, while the male rate, although it has risen in the last five years, remains lower than before the last recession.

In terms of ethnicity, the most notable trend is in respect of Pacific. In 1987 the Pacific Islands population had the highest employment rate of any of the measured ethnic groups. Two decades later their employment rate is lower than that of Māori and Pākehā.

**Table 1: Employment rates, 1987 and 2008 (%)**

| | Sept 1987 | Sept 2008* |
|---|---|---|
| **Total** | **63.8** | **65.8** |
| Males | 75.6 | 71.9 |
| Females | 52.7 | 60.1 |
| Pākehā | 64.1 | 67.5 |
| Māori | 58.6 | 62.5 |
| Pacific Islands | 66.2 | 59.6 |

Source: Household Labour Force Survey. *2008 ethnicity data are for June.

New Zealand has also performed well in respect of unemployment over the last six years: by March 2008 our aggregate unemployment rate, 3.6%, was among the lowest in the OECD. This had risen slightly to 4.2% by September 2008. While the aggregate rate is low, for some groups rates are still significant. In particular, even in a very tight labour market, unemployment among 15–24 year olds remains at over 10%. Using June 2008 data,[3] the Māori rate was 7.7% and the Pacifica rate was 6.3%, compared with a rate among Pākehā of 2.6%. One worrying feature of the Māori unemployment rate is that throughout the last 21 years of Household Labour Force Survey data, the Māori unemployment rate has consistently been between 2¼ and 2½ times the aggregate rate, irrespective of labour market conditions. If this relationship continues to hold, an increase in unemployment to 10% could see a quarter of the Māori labour force unemployed.

**Table 2: Unemployment rates, 1987, 1991 and 2008 (%)**

| | Sept 1987 | Sept 1991 | Sept 2008* |
|---|---|---|---|
| **Total** | **4.1** | **10.9** | **4.2** |
| Male | 3.7 | 11.6 | 4.2 |
| Female | 4.7 | 10.1 | 4.1 |
| 15 – 24 yrs | 7.8 | 17.8 | 10.2 |
| Pākehā | 3.3 | 7.6 | 2.6 |
| Māori | 10.8 | 24.1 | 7.7 |
| Pacific Islands | 6.6 | 26.9 | 6.3 |

Source: Household Labour Force Survey. *2008 ethnicity data are for June.

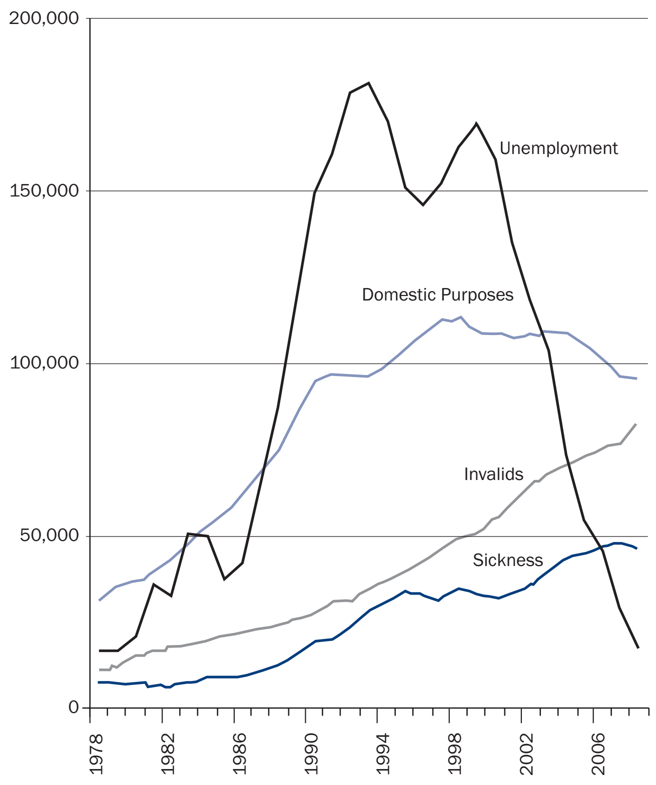
A unique labour market issue that is potentially significant for the current recession is the very high number of temporary workers currently employed in New Zealand. Immigration Service data show that the number of people holding work permits currently in New Zealand has risen from approximately 30,000 in 2001 to 135,000 in June 2008. The great majority of these workers have 1–3-year permits, and many have had their permits renewed at least once. Only about 5,000 or so are short-term seasonal workers. In principle, many of these workers should return home when their permits expire if an easing labour market means that there are now New Zealanders available to fill the jobs. In practice this is likely to depend to a significant extent on whether their employer wants to retain them. A further complication in respect of this group is that it is unclear how many are counted in the Household Labour Force Survey. The survey is only administered to those who describe themselves as 'usually resident in New Zealand', and there is no information on what proportion of work permit holders regard themselves this way.

***Benefit numbers***

One of the starkest differences between the starting point for this recession and that of the late 1980s–early 1990s is the situation regarding beneficiaries. In September 2008 there were 270,000 recipients of the four main benefits – unemployment, domestic purposes, invalids and sickness (8.4% of the working age population). This compares with 167,000 in 1987 (6.5% of the working age population). These figures relate to the principal benefit recipient and do not include spouses and other family members. As at March 2008 approximately 199,000 children were also living in families dependent on these benefits.[4]

The trend in benefit numbers is shown in Figure 1. As can be seen, unemployment benefit numbers have fallen sharply since 1999, reflecting the strong demand for labour, the effects of policy initiatives and Work and Income's effective case management of job seekers. At the same time, the advantages of rapid employment growth were not widely shared by sole parents on the domestic purposes benefit, whose numbers fell by only about 17,000, from a peak of about 113,000 to 96,000 in September 2008. This is likely to reflect the difficulties sole parents have in accessing affordable childcare and out-of-school care that fits with employment

**Figure 1: Benefit numbers by main benefit type, 1987–2008**




Sources: Treasury long-term data series and Ministry of Social Development statistical reports opportunities, and suggests that the in work tax credit has had only a weak impact in making paid work a practicable option for sole parents.

Also of concern is the continuing rise in invalids benefit numbers, which appear to be completely unaffected by the economic cycle. Invalids benefit numbers have risen 350%, from 23,000 in 1987 to 83,000 now. Similarly, sickness beneficiary numbers have increased over the same period, from 11,000 to 46,000. It is possible that in recent years some of this increase is attributable to people transferring from unemployment to the sickness benefit.

***The value of social assistance***

Exacerbating concerns about benefit numbers is the fact that the real value of most benefit incomes is now significantly lower than in the 1980s. Figure 2 plots the real value of the core benefit entitlement plus family assistance[5] from 1973 to 2007 for a sole-parent and a two-parent family with two children. It shows the large fall in the 1989–91 period due to non-indexation and the 1991 benefit cuts, and the increase in assistance from 2005 due to the Working for Families initiatives. Notwithstanding those recent increases, the real value of assistance for beneficiaries with children is still well below what it was in the late 1980s.

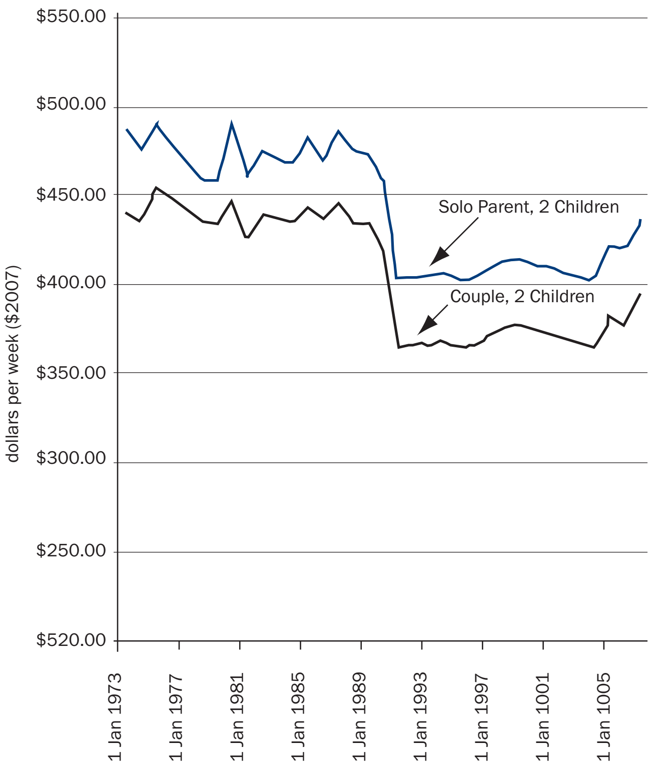
These data do not take into account the entire social assistance package available to beneficiaries; in particular, they do not include housing assistance, to which many beneficiaries are entitled, or third-tier assistance. However, a recent Ministry of Social Development report (Ministry of Social Development, 2007) showed that in 2006 beneficiaries with children living in accommodation supplement areas 2 and 3 (i.e., most cities and towns in New Zealand) who had no other earnings had, on average, equivalised disposable incomes after housing costs and housing assistance of between 30 and 35% of the median.[6]

***Child poverty***

On both absolute and relative measures, child poverty rose steeply in the recession of the late 80s–early 90s. Following this, child poverty rates have trended downwards but, after housing costs, remain higher now than they were prior to 1988. During the growth phase child poverty became more concentrated on children living in (i) households with no adult in work, and (ii) sole-parent households, both of which groups still have child poverty rates (using the 60% of median constant value absolute poverty measure) of approximately 50%. After housing costs, the number of children in poverty in 2006/07 was between 130,000 (12%) and 230,000 (23%), depending on which of the four measures represented in Figure 3 is used.

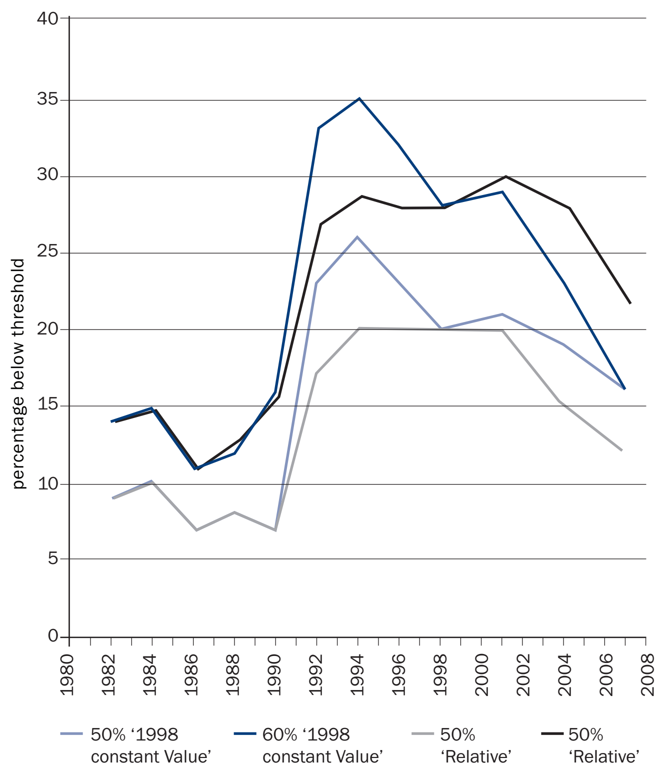
The extent to which New Zealand's social assistance system relies on the labour market to keep children out of poverty is illustrated in Figure 4, which plots absolute child poverty against non-employment. The trend in child poverty follows non-employment closely, with a lag of about 18–24 months. While it is important not to read too much into a simple graphical representation like this, it is notable that there appears to have been only a relatively weak response

**Figure 2: The real value of benefits plus family assistance, 1973–2008**




Source: Fletcher and Dwyer, 2008

**Figure 3: Child poverty rates, after housing costs, 1982–2006/7**




Source: Fletcher and Dwyer, 2008, based on data from Perry, 2008 to the big fall in non-employment in the last three years, presumably reflecting the relatively high number of sole-parent families still reliant on benefits.

Figure 4 is, of course, a matter of significant concern for the future. Unless we do better than in the past at supporting those dependent on benefits, the forecast rise in unemployment and decline in labour market participation will flow directly on to higher child poverty rates. There is now strong evidence of the long-lasting individual, social and economic costs associated with child poverty, especially if experienced by young children.[7]

***Household overcrowding and housing affordability***

We do not have data allowing comparisons of household overcrowding now and 20 years ago. However, 2006 data reported in The Social Report 2008 (Ministry of Social Development, 2008) show 10% of the total population and 17% of children under the age of ten living in overcrowded accommodation, based on the Canadian overcrowding index. Overcrowding is much more common among the Pacifica population (43%) and Māori (23%).

With respect to affordability, almost a third of children and adults under the age of 45 live in households which spend in excess of 30% of their disposable income on housing. The proportion of those in the lowest income quintile who spend this much or more on housing has doubled since 1988.

***Income inequality***

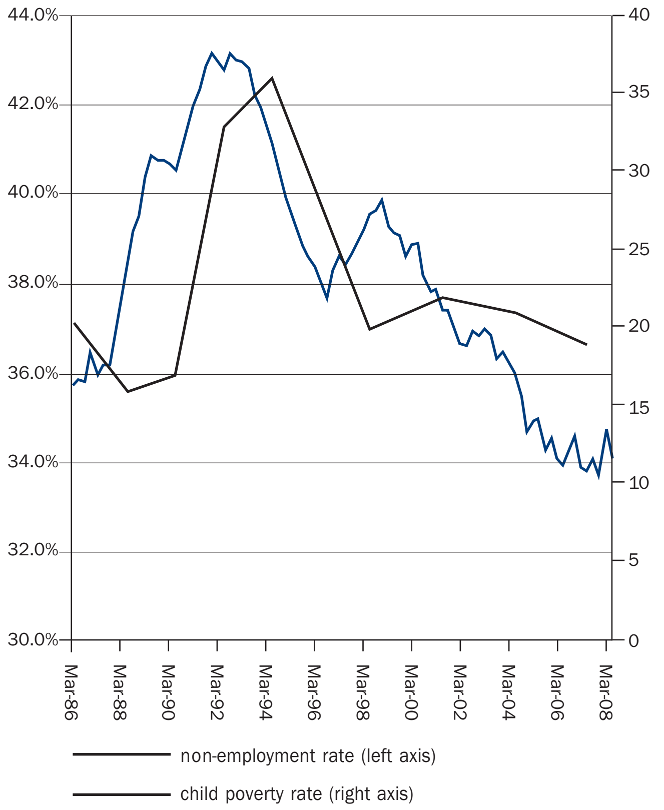
Finally, another big difference between the present situation and that pertaining at the end of the 1980s is that we are entering this recession with a much higher level of income inequality than was the case then (see Figure 5). Income inequality rose more sharply in New Zealand than in any other OECD country over the period from the late 1980s to the late 1990s and remains much higher despite a slight fall in the most recent data.

It is not clear what will happen to income inequality in the next few years. It is possible that the trend will be quite different than in the late 1980s–early 1990s because of differences in the pattern of job losses and earnings trends. One possibility is that the Gini co-efficient measure, which takes into account changes in income across the whole income distribution, will remain fairly flat, whilst the ratio of the 80th percentile to the 20th percentile worsens, reflecting the impact of the recession on the less well-off compared to those in the top quintile.

**Social policy for the recession**

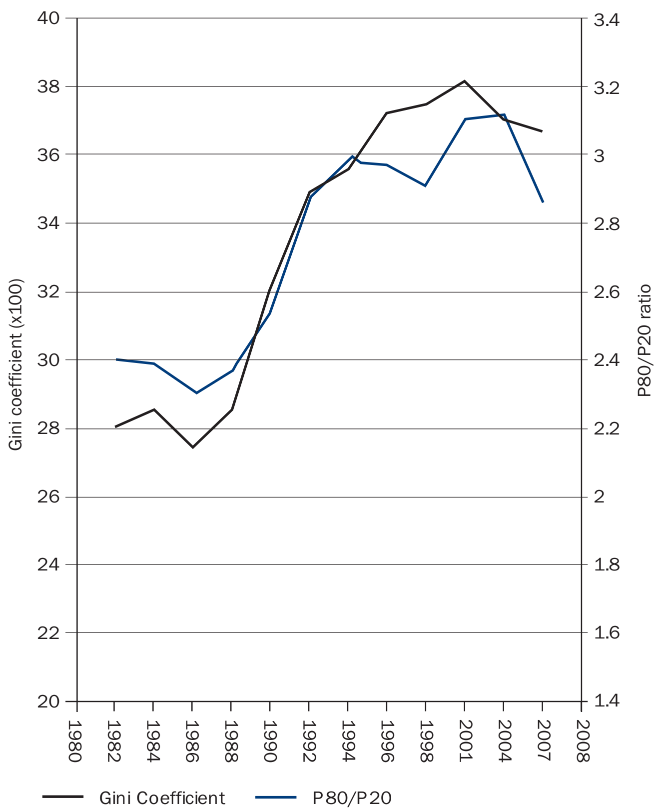
In social outcome terms the comparison between now and the beginning of the recession of 20 years ago is mixed. On the one hand, the aggregate employment rate and labour force participation is higher and the unemployment rate is similar to 1988. On the other hand, though, many of the key indicators of social well-being are significantly worse now compared to then. In particular, beneficiary numbers are much higher and beneficiary incomes significantly lower. Child poverty rates, though lower than in the mid-1990s, are still higher after housing costs than in the 1980s, and income

**Figure 4: Non-employment and child poverty, 1986–2008**




Sources: Household Labour Force Survey and Perry, 2008

**Figure 5: Income inequality, 1982–2007**




Source: Perry, 2008

inequality is much greater than it was 20 years ago.

The second part of this article draws on the experiences of the late 1980s–early 1990s to suggest some principles and priorities that should guide social policy in the recession, and then very briefly discusses three key policy areas – employment policies, education and training, and social assistance and family tax credits.

### *The importance of focusing on distributional impacts*

The 'severity' and 'duration' of a recession are both averages. For some people there will be no recession at all. For others, income losses will be large and will last long after the recession is statistically over. In the last major recession, certain groups experienced long and substantial hardship. These groups can be identified by industry or occupation, ethnicity, education level, or in some cases the community or town they lived in. The situation then was exacerbated by policy settings based on a belief that labour markets would adjust more rapidly than they did and that aggregate losses would be minimised by allowing that adjustment to occur without too much intervention.

The 'severity' and 'duration' of a recession are both averages. For some people there will be no recession at all. For others, income losses will be large and will last long after the recession is statistically over.

One likely difference between this recession and that of 1988–93 is that then the downturn was associated with a process of economic restructuring that was a strong factor in determining the distributional impacts, particularly in respect of employment losses. This time, despite the global financial crisis and the probable need to restructure or re-regulate global financial practices, it is less likely to result in much restructuring of the New Zealand economy, in the sense of significant shifts in output or employment shares. This suggests that it is even more important to maintain, as far as possible, the existing human capital and skills of the workforce and to avoid the extremely high rates of unemployment and poverty and loss of infrastructure that occurred in many New Zealand towns in the late 80s–early 90s.

### *Prioritise the least well-off and children, where the long-term social and economic costs are greatest*

In seeking to ameliorate the negative impacts of the recession, policy makers must aim for some balance between cushioning the effects on those who experience the biggest shocks to their income and/or wealth, and protecting those who are least well-off. There is a risk that too much of the former results in middle-class capture of the available assistance. Quite aside from arguments of equity and social justice, the experience of the 1990s and since is strong evidence of the long-term consequences of not ensuring adequate support for the poorest communities and for children in low-income households.

### *Be aware of the long-term impacts of policy changes on the social policy framework*

Some policies introduced to counter the effects of the recession are reversible – they can either be easily ended when no longer needed, or automatically phased out when circumstances improve. As a result they have no lasting effect on the structure or mix of social policies and welfare provisions. Others do, however, have long-term implications for the overall social policy framework. The 1991 benefit cuts, for example, have never been reversed, despite the evidence of income inadequacy among beneficiaries.

Another example of this issue is the 'Restart' package to assist those who are made redundant that was announced by the government on 15 December 2008. Pre-election versions of this package proposed by both major parties could potentially have introduced into the New Zealand welfare system elements of a two-tier social insurance/safety net structure, where those with a work history receive a period of higher assistance than those without and do not face the same asset tests or spousal income tests. It is, of course, a matter of legitimate debate as to whether a single-tier system, such as New Zealand has always had, is or is not preferable to the two-tier social insurance model common in much of Europe. The point here is that there was a risk that a measure brought in with the intention of alleviating income shocks affecting people made redundant would result in a quite fundamental long-term change to the social security framework without the implications of that change being properly debated.

As it turns out, the government's package appears for the most part to have avoided that risk. The extra assistance is largely targeted at helping those without significant savings or other income, and who face high child-related or housing costs to adjust to the loss of earned income. On the other hand, the package provides only limited assistance and will not help many people affected by the downturn.

## Some brief comments on three specific policy areas

It is beyond the scope of this article to fully discuss each of these areas, but the following are some brief comments based largely on what we know from past outcomes.

### *Employment support*

The extent to which employment levels can be maintained will have a long-lasting impact on subsequent social and economic outcomes. Maintaining jobs through a generalised and protracted recessionary period is, of course, not easy. Attempts to sustain existing jobs through direct employer subsidies may be useful in some targeted situations, but do not have a good track record, owing largely to deadweight cost problems and the difficulties of determining which jobs should be supported. Clearly, demand-side measures can help; as will government infrastructure projects (which should include social infrastructure such as state house building, etc).

In terms of employment programmes for the unemployed, the evaluation evidence from the 1990s showed that wage subsidies for full-time/permanent employment (eg, Job Plus) worked relatively well, while 'work-readiness' and work-for-dole schemes such as Community Taskforce were not effective in increasing people's chance of getting back into employment. Temporary full-time, full-wage, project-based programmes such as Taskforce Green can be beneficial, depending on the project and the quality of administration. One advantage we have now compared with 20 years ago is the considerable improvement in Work and Income's case management processes and in its links with employers and communities at the local level.

A further difficulty with the in-work tax credit is that it is not well targeted as a 'make work pay' measure, since most of the expenditure goes to those higher up the income distribution ...

The issue of targeting of employment assistance will need further analysis. During the 1980s and 1990s, active labour market assistance was targeted mostly at the long-term unemployed (defined in most cases as 26 weeks-plus duration on the job seeker register). The relationship between inflows, outflows and duration means that in the early stages at least, when unemployment numbers will be dominated by new enrolments, a focus on long duration makes little sense. Even later, as the proportion of long-term unemployed grows, it may be better to target other characteristics. Males over 40 years old, for example, are at a higher risk of long-term unemployment than are young people, who tend to experience more, shorter spells out of work. Given what we know of the impact of poverty on children, it may also make sense to focus on those with dependent children, and especially young children.

#### *Training and education programmes*

Past experience shows that short-term training courses, such as ACCESS, Māori ACCESS and the Training Opportunity Programme (TOP), are not very effective either in raising participants' skill levels or in enhancing their subsequent employment chances. It would be better to put considerable money into subsidising longer-term education and training opportunities of the sort that lead to meaningful skill acquisition and recognised qualifications. Even in a downturn in demand for many trades and similar services, there will be opportunities to subsidise modern apprenticeship places in many occupations. In addition to the benefits to those taking up apprenticeships, such a policy would ensure that a good supply of skilled workers is available when demand picks up.

There is scope, too, to expand access to the training incentive allowance which helps beneficiaries with tertiary education, including university study.

#### *Benefits and tax credits*

Benefit rates are lower than they were in the 1980s and entitlements are below what is necessary for many beneficiaries to avoid poverty and significant hardship. Notwithstanding worsening government accounts, there is a strong case for raising benefit levels to ensure the recession does not result in the same rapid increase in child and adult poverty that New Zealand experienced in the 1990s. In that period, the long-term effects on the individuals affected and on wider social and economic outcomes were clear.

As well as increasing core rates of benefit, it would help to adopt an indexing regime similar to that used for New Zealand Superannuation – annual CPI adjustments within a band linked to average wages. The effect of this would be to constrain benefit rate increases if the recession results in falling real wages, while at the same time ensuring that over the long term benefits maintain relativity with wages.

Accommodation supplement (AS) maxima also need increasing – and could perhaps be increased ahead of benefit rates as an interim, more targeted measure. The proportion of AS recipients who have reached the maximum has been increasing steadily and is now over 30%. The government's 'Replace' assistance to those made redundant is a limited step in this direction, albeit available to only a very narrow group of AS recipients and for only a short period of time.

Weak labour demand accentuates the case for revising aspects of the Working for Families package. The package – which undoubtedly provided substantial, much-needed assistance for many families – was designed to take advantage of a strong labour market by encouraging beneficiaries with children to move off benefits and into paid work. In circumstances of falling employment, components of the package such as the in-work tax credit are unlikely to have any effect in reducing unemployment. A further difficulty with the in-work tax credit is that it is not well targeted as a 'make work pay' measure, since most of the expenditure goes to those higher up the income distribution, for whom the gap between wages and benefits is not relevant.

In a situation of falling employment and rising benefit dependence it would be preferable to remove the in-work tax credit and transfer the expenditure to an increase in the core family tax credit. At the same time it would be possible to simplify the current five family tax credit rates (which are largely historical accidents) in such a way as to give relatively more of the additional expenditure to families with young children. Poverty in the early years is known to be most likely to have lasting detrimental effects, and, in addition, it is when children are young that families tend to have the greatest financial difficulties.

### Conclusions

New Zealand is entering what appears likely to be a serious and protracted recession with a mixed set of social indicators. While employment is high and unemployment low, the number of people dependent on benefits is considerably higher than at the beginning of the last significant downturn, and the incomes of beneficiaries are lower. Income inequality is also much higher than it was 20 years ago.

The experience of the 1990s suggests that, quite apart from arguments of social justice, a deliberate policy focus on expenditures to minimise the impacts of the recession on the most vulnerable, and especially on children, will significantly improve New Zealand's social and economic indicators after the recession is over. This article touches on only a small number of the range of policy initiatives needed to achieve this.

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1 An earlier version of this paper was presented at the Institute of Policy Studies symposium 'New Zealand Economic and Social Policy in the Face of the Global Crisis', held on 22 November 2008.
2 Technically that recession was over a much shorter period, but the period of low employment growth and high unemployment lasted that long.
3 Consistent September quarter data are not available as Statistics New Zealand has changed its ethnicity classifications from a hierarchical method to a multiple-response method. Backdated data using the new system are expected to be available shortly.
4 I do not have September 2008 data or a comparable figure for the 1980s.
5 Family benefit, family care, family support and family tax credit.
6 The minority with some earnings in addition to their benefit had incomes averaging about 43% of the median.
7 See, for example, Hirsch, 2006 and Poulton *et al.*, 2002.

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Dennis Rose

# Executive Power and the Head of State: Issues Arising from Proposals to Establish a Republic

## Introduction

In New Zealand executive power is concentrated in the hands of the prime minister and ministers, all being members of an elected parliament upon whose continuing support they depend. This substantive power relationship is embedded in a constitutional structure in which an appointed governor-general acts as head of state, as representative of the monarch, who is also the monarch of the United Kingdom. By convention and law the head of state acts on the advice of the prime minister and ministers in all but exceptional circumstances.

Reliance on a geographically remote monarch seems anomalous to many and it is likely that at some point New Zealand will sever its ties with the English Crown and establish a republic with either an appointed or an elected head of state. But there is uncertainty about the extent to which proponents of change in constitutional form also envisage change in the substantive power relationships existing between the prime minister, Cabinet, ministers of the Crown and Parliament. The head of state occupies a pivotal position in relation to the executive, legislative and judicial branches of government so that any change in the form, function or powers of the head of state is likely to have wide ramifications.

Such changes are best made after an ongoing debate in which major issues have been identified, options canvassed and implications considered. It would be wrong to assume that a change from a monarchy to a republic is essentially a matter of form, easily accomplished at a convenient

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moment, such as following the death of the current monarch. The 1999 Australian referendum, on a republic with an appointed head of state, provided an object lesson on the pitfalls of putting one particular republican form to a vote in an environment where public discussion had not generated sufficient clarity around the main alternatives that might have been considered.

This brief article seeks to identify the major issues likely to arise in designing a republican constitution, particularly those relating to the role and powers of the head of state. It outlines a programme by which these issues might be explored. The objective is to clarify the implications of various possible changes rather than to advocate any particular course of action. Indeed, it is possible that we should be making no change at all. But that is a decision for the electorate as a whole, ideally informed by an understanding of the likely implications of various possible changes as compared with existing arrangements.

The powers of a head of state and the mode of selection are interrelated. Election establishes a democratic mandate and with that a common expectation that the person elected carries more authority than he or she would have if simply appointed. This interdependence suggests ordering our discussion around alternative views on the range of powers that might be accorded to the head of state.

I first review what would be involved in maintaining the current constitutional balance between an appointed governor-general and a prime minister responsible to Parliament, whilst severing the link to the Crown. I consider two options, under each of which the governor-general continues in his or her current role. Under the first option the governor-general is simply elevated to the position of head of state. Under the second option an additional formal entity is created, available for advice during times of constitutional stress and hopefully over time accruing some of the symbolic status that currently attaches to the monarch. Under either option various methods of appointment are possible. I then look at models where there is an elected president, starting with the Irish example, where the president exercises a fairly minimal set of additional powers. Next I consider what have been characterised as 'semi-presidential' systems, where an elected president shares some element of executive power with a prime minister responsible to an elected legislature, and conclude with reference to full presidential systems as in the United States, where the president heads the executive arm of government.

#### The current position in New Zealand – an appointed governor-general

The governor-general, appointed on the advice of the prime minister and government, represents the Queen, as sovereign of New Zealand. In recent decades all governors-general have been New Zealand-born, with significant records of participation in public affairs. The governor-general performs important constitutional and ceremonial roles such as opening (and dissolving) Parliament, swearing in ministers, receiving the credentials of foreign diplomatic representatives, and investitures. In addition, governors-general maintain a busy programme interacting with New Zealand communities and, on occasion, make state visits overseas. The governor-general regularly chairs meetings of the Executive Council, formally approves legislation on behalf of the monarch and, centrally, holds important powers in relation to the appointment of the prime minister and the dissolution of Parliament.

As in other parliamentary democracies of the Westminster type, the governor-general ordinarily follows the advice of the prime minister, and ministers, in exercising his or her legal powers, to the extent that some have seen the post as little more than a rubber stamp. But governors-general possess reserve powers that may be exercised in exceptional circumstances, without the advice of ministers. The main reserve powers are: to appoint a prime minister; to dismiss a prime minister; to refuse to dissolve a Parliament; and, in limited circumstances, to force a dissolution.

the essential point is that reserve powers ... are a necessary underpinning in constitutional systems where the prime minister [is] able to maintain the support of a majority in Parliament.

There have been no recent incidents of significance in New Zealand, but the 20th-century history of Commonwealth countries (including the United Kingdom), and of the constitutional monarchies of Western Europe, records significant interventions by heads of state, in relation to the position of the prime minister or the dissolution of Parliament. Three examples will suffice. In 1931 King George V encouraged the Labour prime minister, Ramsay MacDonald, faced with a serious division in the Cabinet, to form a 'National' government in alliance with members of the Conservative opposition, thereby splitting his own parliamentary Labour party. In 1975, the Australian governor-general, Sir John Kerr, dismissed the prime minister, Gough Whitlam, and, more recently, Fijian governors-general have played a role in the aftermath of military coups.

Such events are inevitably controversial. But the essential point is that reserve powers, wisely used or not, are a necessary underpinning in constitutional systems where the prime minister depends upon his or her being able to maintain the support of a majority in Parliament. That support will occasionally fail and whilst, in the normal course

... attempts to codify the circumstances under which...reserve powers should be exercised ... may unreasonably limit the head of state's powers to act appropriately in extreme circumstances

of events, the parliamentary players will resolve the problem themselves, there may come a point where the head of state sees a need to act, so as to resolve a hiatus or to protect the constitution. Attempts to codify the circumstances under which such reserve powers should be exercised are unlikely to cover every contingency and may unreasonably limit the head of state's power to act appropriately in extreme circumstances.

The governor-general, as a member of the Executive Council, and as the assenting signatory to bills passed by Parliament, is privy to important political matters. In Britain the Queen is seen as having the right, and some argue duty, to express her views on such matters to ministers, conditional on keeping those views private, and subject to the ongoing obligation to act on the advice of those ministers. Dame Sylvia Cartwright, speaking towards the end of her term as governor-general of New Zealand, reported: 'Executive Council meetings, which are generally held every Monday, give me the opportunity – and I take it on a regular basis – to ask Ministers questions about the conduct of government business' (Cartwright, 2006). Governors-general are politically aware citizens. The need to maintain, and to be seen as maintaining, political neutrality in the performance of their role necessarily circumscribes their ability to take a public position on major issues of the day. Nevertheless, governors-general are expected to speak on an extraordinary range of occasions and will, inevitably, sometimes touch upon politically sensitive issues.

**Minimalist change – an appointed president**

What would be involved in a minimalist change from the present structure?

The key change would be severance of the tie to the Queen of England. Under our first two options this entails elevating the office of the governor-general from its current position as Queen's representative to head of state in its own right. Current arrangements for the selection of a new governor-general, or president, would remain in place but the detailed mechanics of appointment would have to change.

At present the government recommends the chosen person to the monarch for approval and appointment as governor-general. By convention the monarch accepts the recommendation, but there is an inherent possibility that she, or he, might query or object to the suggestion. So it would be sensible to expose the prime minister's recommendation to scrutiny by an external body. Obvious possibilities include: Parliament, a committee of MPs (in effect extending the current practice of prior consultation with the leader of the opposition); a panel of eminent persons (selected by position or eminence); or a panel of citizens. The proposal embodied in the 1999 Australian republican referendum envisaged that the president would be appointed by two-thirds majority vote of the House of Representatives, following nomination by the prime minister and secondment by the leader of the opposition. An earlier Australian proposal, advanced during the 1990s by Richard McGarvie, was to create a three-member Constitutional Council, appointed by formula from former governors-general and judges. The council, on receipt of advice from the prime minister, would appoint his or her nominee as governor-general. The council would also be required to dismiss an incumbent governor-general within two weeks of receiving advice from the prime minister.

As New Zealand head of state, the Queen, normally through the governor-general, but occasionally in person, plays key symbolic roles in relation to the judicial system and to the armed forces. The 'Crown' of itself is a powerful and ubiquitous symbol, and particularly in some areas, such as Māori-Pākehā relations and the Treaty of Waitangi, is seen as having more than symbolic status. Treaty-related issues are discussed separately later, but the symbolic status of the Crown suggests a need for a review of the likely consequences, across the field, of removing the link to the 'Crown' and an exploration of mechanisms that might possibly augment or complement the role of an appointed head of state. The hereditary monarchy, combining as it does long history, echoes of once awesome powers, and a more recent but still long tradition of studiously apolitical behaviour, provides a convenient politically neutral personification of the state. The past few decades have probably weakened that status but it remains strong. Nation states require symbolic central reference points, so that removal of the status and symbolism of the monarchy suggests a need to consider institutional innovations to replace them.

Under our second minimalist option an attempt would be made to vest some symbolic power in New Zealand entities or sites whilst maintaining the current position and powers of the governor-general (possibly renamed president).

A written constitution, formalising the key power relationships within the state, would itself constitute a powerful symbol. Another obvious possibility would be to augment the role of the body responsible for approving the prime minister's recommendation on appointment of the governor-general. In practice the governor-general already acts as head of state, and the Queen's role is essentially symbolic. That said, it is always the case that persons in positions of authority will, under some circumstances, find it useful to be able to seek advice and guidance. A Constitutional Council, with a wider role than that proposed by McGarvie in Australia, would provide a legally constituted reference point, available to offer advice, for example, to a governor-general contemplating exercise of the reserve powers at times of constitutional stress or crisis.

Removal of the monarch effectively removes a layer of recourse from within the constitutional structure and thus may occasion a need to review the constraints within which a New Zealand head of state would operate. Under our second option the New Zealand entity (possibly named a Constitutional Council) would provide an additional layer of responsibility and recourse within the system and could be expected to accrue symbolic status over time.

More generally, either of our two minimalist adjustments would require amendment of a substantial swathe of legislation, including a rewriting of the Constitution Act and almost certainly further codification of the constitution.

### An elected president – a minimalist model

Election confers a democratic mandate to a president, particularly when election is by popular vote rather than indirectly through Parliament. A popular mandate inevitably brings some degree of extra moral authority, and thereby potential power. It is also likely that election will bring change to the range of persons from which presidents are selected. Political parties are likely to nominate candidates, so that elected presidents can be expected to have rather more strongly defined political characteristics than appointees. Some non-party persons who would accept an appointed position may well blanch at submitting themselves to a competitive national election.

Election establishes a president in that position as of right and so encourages more confident expression of personal opinion. Any such tendency will, however, stand in conflict with the convention that the head of state in a parliamentary system does not express him or herself in public on major policy issues. The term of Mary Robinson as elected president of the Irish Republic illustrates the tensions that may be generated when previously active politicians succeed to the presidency.

In her inaugural address Robinson identified issues which she would like to address during her presidency, several of which led to tensions between her and the elected government. In 1992 Robinson expressed sympathy for the sense of frustration felt by Irish women and girls in the face of a government decision to restrain a young woman travelling to Britain to secure an abortion. In 1993 Robinson shook hands with Gerry Adams of Sinn Fein at a meeting in west Belfast, at a time when Sinn Fein was banned from Irish and British broadcasting and Adams denied a visa to the United States. Robinson's strong interest in human rights in the Third World led to an invitation to co-chair a panel on the future of the United Nations, an invitation that she declined only after strong political pressure.

The Irish constitution provides mechanisms by which the president may refer legislation to the Supreme Court to test its constitutionality, or, in response to a petition from the Senate, withhold his or her signature pending a referendum or dissolution of the lower house. These provide more explicit, but also more circumscribed, mechanisms than the shadowy and rarely used power of a governor-general in most Westminster democracies to seek to modify a bill by refusing assent. In New Zealand explicit powers to withhold assent, and indeed to amend bills, which had been a feature of New Zealand law from colonial times, were omitted from the replacement Constitution Act of 1986. It was asserted that the change did not affect the underlying power, subject, as it is, to the strong convention that the governor-general follows the advice of responsible ministers in all but exceptional circumstances.

There are, of course, many other examples of elected presidents with normally minimal, but potentially important, powers. Because an elected president with limited powers is the most likely alternative to an appointed presidency, it would be useful to review experience in an array of countries, such as Ireland, Finland and India, with particular reference to the powers accorded to the president, to the constitutional constraints under which the president operates, to the sources of advice available to the president, and to the mode of election.

### Shared powers – a semi-presidential system

The term 'semi-presidentialism' is variously defined, but I use it to describe systems in which there is an elected president, constitutionally endowed with personal prerogatives, alongside a prime minister and ministers entrusted with executive and governmental powers that they can exercise only so long as Parliament leaves them in office. The constitutional boundary between presidential and prime ministerial powers differs from case to case, with particular significance attaching to the role of the president in relation to the appointment of the prime minister, the relationship between Cabinet ministers and the legislature, presidential approval of legislation, recourse to emergency powers, and the president's role in foreign affairs. Experience shows that much also depends on the party affiliation and position of the president, the personalities of the prime minister and

Historically important examples of semi-presidential states include Weimar Germany, where the division of powers, along with the extreme form of proportional representation in the Reichstag, were held to have contributed to the failure of that system in the face of Nazism, and France since 1958, under the fifth republic.

A vote on whether or not to move to a republic is likely to be conditional on the form of republic proposed.

president, circumstances prevailing at particular moments and evolving precedents.

Historically important examples of semi-presidential states include Weimar Germany, where the division of powers, along with the extreme form of proportional representation in the Reichstag, were held to have contributed to the failure of that system in the face of Nazism, and France since 1958, under the fifth republic. In the post-war period many newly independent nations and, more recently, many of the successor states to communist regimes in the former Soviet Union and Eastern Europe have adopted semi-presidential systems. The multiplication of practical examples has led to increased academic attention (Duverger, 1980; Elgie, 1995; Siaroff, 2003; Skach, 2006, Power, 2008).

Division of power between a president and a prime minister, taken together with the fact that each can claim a democratic mandate, creates the possibility that differences between the two, on important issues of policy, or in times of emergency, will lead to conflict over who has final decision authority. Grey areas in law may encourage intransigence and create situations in which the president is tempted to exert undue influence on the basis of his or her constitutional ability to exercise emergency powers, buttressed as those usually are by a constitutional role as commander-in chief of the armed forces.

The boundary between presidential and prime-ministerial powers is clearly critical. That it also lies on a continuum is illustrated by the fact that the Irish constitution, which subjects the executive government to the oversight of Parliament, is nevertheless sometimes categorised as semi-presidential. If the constitutional debate in New Zealand is to include semi-presidentialism as a form to be considered, that debate would desirably be informed by analyses of the range of prerogative powers that might be accorded to a president, how these might impact on the powers of the prime minister, and their implications for the body of New Zealand law.

#### A presidential system

A full presidential system along American lines is the final option to be considered. The 2004 Australian Senate inquiry report The Road to a Republic concluded, on the basis of survey data, that this option was not widely favoured in Australia. Nevertheless, such a model will be in some people's minds when they talk of movement to a republic and it seems sensible to canvass this option within any programme aimed at testing public opinion on republican options in New Zealand.

The essential feature of the American system is that executive power is concentrated in the president and that there is no prime minister. The legislature exists as a separate arm of government and, impeachment for misconduct aside, does not have the power to bring down the president. It does have the power to veto appointment to some key government positions and it may also frustrate the executive by refusing to pass legislation promoted by the executive or by passing legislation contrary to its wishes. The president and the legislature are elected by popular election, but there is nothing in the system to guarantee that the executive arm as a whole has the confidence of the legislature. Different political parties may hold the presidency and effective power in the Congress.

Any move to a system approximating that in the United States would be a truly radical change and would require parallel consideration of issues such as the adoption of a written constitution and the constitutional separation of powers between the executive, legislative and judicial branches of government.

#### Powers of the prime minister

Our focus has been on the powers that might be accorded to a president under various constitutional options. The range of issues that have arisen suggests that it will be sensible to review in parallel the powers to be accorded to the prime minister under that same set of options. Movement from a monarchy focuses attention on the powers of the new head of state and whether these should be reduced or augmented. Coming at the issue from the perspective of the contemporary functioning of New Zealand's parliamentary democracy, the role of the prime minister is properly seen as central. Indeed, some argue that the powers of a prime minister, responsible to a single house of Parliament, are greater than those enjoyed by a president constrained by constitutionally separate legislative and judicial arms. This possibility suggests a need to consider institutional changes that would constrain prime ministerial powers, in areas such as the timing of elections. MMP has augmented political constraints on the position of prime minister but the constitutional issue remains.

The primary focus for many of those seeking a republic is the move from the monarchy and it is not clear whether advocates of change are content with the basic framework of a prime minister dependent on the continuing support of a majority in Parliament, or whether they are also seeking change in this central, and arguably more fundamental, feature of New Zealand's constitutional system. There is therefore a strong case for examining the role and powers of the prime minister within our Westminster system, and considering how these might change under different republican alternatives. A vote on whether or not to move to a republic is likely to be conditional on the form of republic proposed.

#### Wider issues

Despite its largely symbolic status, the Crown is central to the constitutional framework. Its removal would affect power relationships along several dimensions. This article has focused on the relative powers of the head of state and the prime minister, but other relationships will also be affected. What is the role of Parliament in relation to the head of state? Does it play a part in selecting and appointing that person? Does it have a constitutional role enabling it to remove the head of state from office in some circumstances? What is the role of the head of state with reference to legislation passed by Parliament?

Any constitution embodies a system of checks and balances. The powerful position of a prime minister supported by Parliament is ultimately subject to the will of the electorate. In the shorter term it is subject to the law, as interpreted by the courts, and to the potential exercise of such powers as the head of state may exercise. If the chosen constitution holds those powers to a minimal level then it may be appropriate to consider again the case for a second parliamentary chamber.

Any wider rewriting of New Zealand's constitutional arrangements should desirably also consider their relationship with the evolving pattern of international law and precedent. Nations do not exist in isolation, and in recent decades national legal structures have been affected by the developing pattern of international law on human rights and the developing integration of commercial law between groups of countries. New Zealand's legal framework, like its constitutional structure, was nurtured within the template of British law. A stocktake at this point in time will show many linkages to international covenants, some of which may be sufficiently fundamental as to warrant explicit constitutional linkage.

The Crown has a continuing role as signatory to the Treaty of Waitangi. Most Māori and Pākehā commentators see a sharp contrast between the undertakings made when Governor Hobson signed the Treaty on behalf of the Crown and the actions of successor settler governments, actions which created the grievances that give rise to the continuing series of Treaty claims and settlements. Contemporary settlements are, of course, agreements between the Crown and affected Māori. Removal of the Crown from the constitution and the likely codification of the constitution will raise major issues for Māori. Identification and resolution of these issues may well be difficult and time-consuming and will require ongoing cross-cultural dialogue. Consideration of a move to a republic will in any event need to be carried


### Burning Issues: Climate Change, Science, and Religion

### *Making Climate Change a Religious Issue*

*Presented by Professor Bob White FRS*

Why does scepticism persist around the idea that global climate change is caused by human activity? Such attitudes have been particularly prevalent in some conservative religious groupings. In this presentation, Bob White summarises the scientific evidence for anthropogenic climate change, and offers a theological and ethical analysis suggesting why Christians and other religious believers should take climate change seriously in their faith and practice.

Tuesday 10 March 5.40 pm-7.00 pm
Old Government Buildings, lecture theatre one, Victoria University's Pipitea Campus
RSVP to ips@vuw.ac.nz or anglican@vuw.ac.nz

*Presented by the Institute of Policy Studies and the VUW Anglican Chaplaincy*

### Climate Change and Risk Management for Mitigation

*Presented by Professor Stephen Schneider by video-link*

Dr Schneider's talk will focus on techniques and the need for risk management in adapting strategic plans for business, local bodies and engineering for potential impacts of climate change, given the uncertainties in future projections of global climate change and related impacts. The presentation will be particularly relevant for those within business, local bodies and engineering charged with strategic planning and risk management.

Wednesday 18 March 5.30 pm-7.00 pm
Rutherford House, lecture theatre one, Victoria University's Pipitea Campus
RSVP to Barbara.gillespie@vuw.ac.nz

*Presented by the Climate Change Research Institute and the Institute of Policy Studies in the School of Government at Victoria University*

Recent parliamentary enquiries in Australia and New Zealand have extensively discussed the processes of public consultation and decision making appropriate in considering proposals for constitutional change.

forward deliberately in a wide-ranging process of community engagement. It is important to recognise from the beginning that a necessary part of that process is ongoing engagement with Māori. These issues are canvassed extensively in Matthew Palmer's *The Treaty of Waitangi in New Zealand's Law and Constitution* (2008) (see particularly pages 245-8).

### The public process

Recent parliamentary enquiries in Australia and New Zealand have extensively discussed the processes of public consultation and decision making appropriate in considering proposals for constitutional change.

The Australian Senate legal and constitutional references committee 2004 report, *The Road to a Republic*, recommended a three-stage consultative process leading to a binding fourth stage constitutional referendum. The first step would be an initial plebiscite asking whether Australia should become a republic with an Australian head of state, separating from the British monarchy. If change was favoured, a second plebiscite would ascertain preferences as between the following five methods of selecting a head of state:

- prime ministerial appointment;
- appointment by a two-thirds majority of a joint sitting of Parliament;
- appointment by an electoral college, elected on the same basis as the Senate;
- direct election of Parliament's candidates, powers of head of state to be codified;
- direct election by the people, powers of head of state to be codified.

Arguably, the suggested process is flawed, inasmuch as the response to the first question could be conditional on the preferred method of selecting the head of state.

The committee recommended that the third step of the process should be a drafting convention to fine-tune the details of the preferred type of republic and to prepare drafting instructions for a constitutional amendment, to be voted on in a referendum. Membership of the drafting convention would be determined by Parliament and should comprise constitutional experts and others with recognised relevant skills and abilities.

The republic was discussed at the recent Australia 2020 Summit. The preparatory *Initial Summit Report* included, as the first of its 'top ideas' on Australian governance, an interesting suggestion for incremental change:

Introduce an Australian republic, via a two stage process, with Stage 1 ending ties with the UK while retaining the Governor-General's titles and powers for five years. Stage 2: Identifying new models after extensive and broad consultation. (Australia 2020 Summit, 2008)

The Summit report endorsed the idea of 'An Australian Republic' along with some other, possibly demanding, constitutional issues, in particular 'reinvigoration' of the Federation by promoting state-level harmonisation and regulatory reform, and recognition of 'first peoples' custodianship' in the preamble to the constitution. With republican advocates in office as prime minister and as leader of the opposition, these explorations can be expected to continue.

The New Zealand Inquiry to Review Existing Constitutional Arrangements (2005), chaired by Peter Dunne, drew heavily on a report prepared by Matthew Palmer and others for the committee, entitled *Processes for Constitutional Change in New Zealand*. Key parts of the process were seen as accurate information, non-partisan mechanisms for facilitating discussion, engagement with Māori, and public decision-making processes, including referenda. The authors emphasised the need 'to give the community sufficient time to absorb and debate the information, issues and options'.

The need for public engagement and ongoing exploration of options over time is widely acknowledged and many see this as requiring facilitation and oversight by some temporary or permanent public body. The Australian Senate committee recommended a parliamentary joint standing committee. The New Zealand committee recommended, by majority, that the government consider whether an independent institute could foster better public understanding of, and informed debate on, New Zealand's constitutional arrangements. Many of the papers in the Institute of Policy Studies volume *Building the Constitution* (James, 2000) also discuss the processes of engagement necessary to successful pursuit of constitutional change. More recently, Mike Moore, Simon Upton and Peter Dunne have detailed possible approaches in articles in the *Dominion Post*.

### Conclusion

In an earlier presentation of this paper, I identified the research priorities listed in the box and suggested that the range of topics reflected the complexity inherent in proposals to sever the link to the Crown. The fundamental issues arising around the powers of the head of state are to some extent masked because those powers are currently reserve powers, lightly defined and rarely used, and because powers, whether written in law or not, may, in practice, prove ineffective or have unanticipated effects. Any decision to change the prerogative powers of the head of state is likely to require an associated re-balancing of other constitutional elements and, probably, formal enshrinement of those powers in a written constitution.

***Priorities for research***

This article has identified a number of research priorities that could usefully be addressed at an early date to help inform public consideration of possible directions of constitutional change. These priorities are summarised below.

***The reserve powers of the head of state***

Rarely used though they are, the reserve powers are fundamental to the position of the head of state and to the functioning of a Westminster democracy. Because codification can only go so far, it is important to ensure that the head of state and political leaders have ready access to advice on these powers. An up-to-date history of the use of such powers in parliamentary democracies would help sketch the expected place of the reserve powers in any new constitutional set up.

***Minimal change – an appointed governor-general or president***

(a) Explore methods of appointment and removal of the head of state. Also explore institutional and constitutional mechanisms that might augment, complement or regulate the role of an appointed governor-general or president in the absence of a monarch.

(b) Review the implications of removing the 'Crown' from New Zealand legislation.

***An elected president – a minimalist model***

Review experience in countries such as Ireland, Finland, Germany and India, with particular reference to the constitutional powers accorded to the president, to the constitutional constraints under which the president operates, to the sources of advice available to the president and to the modes of election and removal.

***Semi-presidential systems***

Analyse the range of prerogative powers that might be accorded to a president and associated changes in the executive powers of ministers. Examine how these changes would affect the powers of the prime minister and parliamentary oversight of ministers and their implications for the body of New Zealand law and the design of the constitution.

***A presidential system***

I think it unlikely that New Zealand electors would favour concentrating executive power in the hands of a president not dependent on the continued confidence of Parliament. But the possibility exists, so there is need for a preliminary sketch of the constitutional form and legislative implications of a substantial shift of executive power from the prime minister to a president.

***The position and powers of the prime minister***

Although discussion of a republic focuses attention on the position of the president, there is a parallel need for analysis of the role of the prime minister within the range of constitutional frameworks being considered. What is needed is a positive description of the role and powers of the prime minister and Cabinet within each of these possible constitutional frameworks and consideration of desirable institutional checks and balances on their role and powers.

***The position of Māori***

Given the Crown's role as a signatory to the Treaty of Waitangi, any changes involving diminution or removal of the Crown from the constitution will have an impact on Māori and on Māori-Pākehā relations. In exploring constitutional alternatives there is a need for an ongoing and parallel engagement with Māori.

***The public process***

Finally, there is a need to review the processes by which possible change in the role and location of the head of state might be progressed. Recent parliamentary enquiries in Australia and New Zealand provide a logical opening point, but the debate on process needs to proceed, hopefully to the point where, as envisaged by the Australian Senate enquiry, an agreed consultative timetable could be enshrined in legislation.

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Evert Lindquist

# Waiting for the Next Wave: Trajectories, Narratives and Conveying the State of Public Sector Reform[1]

**Overview**

With the adoption of the State Sector Act in 1988, the New Zealand public sector revolution was in full motion. The Act was one of many initiatives that provided a new framework for government and managing public services (Boston et al., 1996; Scott, 2001). New Zealand rapidly became the poster child for what became known as the New Public Management, and an archetype scrutinised around the world. The audacity and intellectual coherence of the New Zealand model became a standard against which the progress of other governments was judged. These reforms were part of a larger social and economic transformation which led to dislocation and democratic reform. In the crucible of introducing and implementing these reforms, and in the inevitable re-adjustment phases, New Zealand gained a reputation for continuous reflection on its progress by its political leaders, government officials and a small band of impressive academics.

The 20th anniversary of the State Sector Act comes at an interesting time. Many academics and even government officials are proclaiming that the New Public Management (NPM) is dead, that we have moved into a post-NPM environment (e.g. Christensen and Laegrid, 2007), and that the ascribed features underpinning NPM will no longer serve as a compass for the next wave of reform. But there continues to be an appetite for renewed commitment and coherence when it comes to reform. A second wave seems to be taking shape – that of integrated, joined-up or horizontal governance – but I sense much less naïve enthusiasm about it, even as officials and entrepreneurs position themselves to ride and shape it, along with a band of academics waiting to criticise the next acronym. Many leaders have experienced a succession of reforms and see, all too well, the many elements

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of continuity. However, bobbing in the waves does not mean treading water: there continues to be great change in store, with a multiplicity of pressures on public sector institutions.

This article seeks to provide some high-level probes into various facets of this 'moment'. Are we in the midst of a new wave that has all but formed? Or are we still waiting for a different wave? Or are we in choppy waters on the surface, unaware of deeper currents and realities below? To animate these questions, I tap into literature from organisation theory that has only recently begun to creep into the public administration literature – a long overdue development (Lindquist, 2008). This writing encourages us to identify disjuncture between espoused theory and experienced realities flowing from announced public sector reforms, to seek out distinctive narratives, and to challenge rhetoric which suggests categorical approaches or situations.[2]

In this article I suggest that public service institutions and observers inadequately convey how our institutions have changed in concrete terms, thus allowing high-level framing and re-framing debates to swirl around. Academics can be too focused on higher-level sets of ideas and getting ready to deconstruct the next reform, while practitioners are grappling with challenges, issues and practice in specific areas, and, in turn, governments and institutional leaders episodically seek to launch the next reform. These dynamics will continue for good reasons, but we can do a better job of sizing up progress on public sector reform by taking closer looks at how our bureaux and other instruments work, particularly in comparative terms. To leaven the debates based on swirling narratives about public sector reform, we need to invest heavily in better ways to convey that experience and progress to date.

Many academics and even government officials are proclaiming that the New Public Management is dead...A second wave seems to be taking shape that of integrated, joined-up or horizontal governance

#### Riding and waiting for public sector reform waves

The New Zealand model of public sector reform of the 1980s will always be held out as an archetype because of the coherence and sharpness of its design, the engagement of the government with key central agency officials, and the swift, staged process of enacting reforms affecting all facets of government: structure, appointments, business models, new accountability regimes, etc. Even if many of the reforms were about making up for lost time in terms of modernising the government and the economy, they nevertheless set a standard against which the reforms of all other countries were judged. Governments and public service leaders in other countries, such as Canada, were criticised for a lack of boldness and coherence in advancing public sector reform (e.g. Aucoin, 1995).

The fiscal stress on governments emerging during the late 1970s and 1980s had led to a decline in the credibility of and satisfaction with traditional governance models, repertoires (across-the-board cutbacks) and competence. The quality of governance and public administration became a political issue and needed to be dealt with in some measure. A new set of sensibilities and prescriptions were variously built up under the labels of managerialism, re-inventing government and alternative service delivery, and eventually took shape as the New Public Management. These ideas and approaches had been debated, acknowledged, and selected in varying degrees by many governments as the best contending ideas for moving away from the status quo (Kingdon, 2003). NPM-style ideas were leading contenders to underpin change, and, in political and economic environments where business practices and institutions had more credibility, it was no surprise that many Western governments and institutions like the OECD were anxious to be, at the very least, seen as embracing these ideas – what Meyer and Rowan (1977) would call normative alignment. New Zealand's reforms became closely associated with the NPM movement, along with initiatives in other countries.

No matter how attractive many of the aspirations and approaches ascribed to the New Public Management movement were, different jurisdictions took up and introduced reforms in varying mixes, degrees and pacing.[3] This diversity has led observers to acknowledge different degrees of interest, trajectories and mixes of initiatives for public sector reform across countries (Pollitt and Bouckaert, 2000). This diversity was driven by two things:

- It is now well understood that, when proceeding with reform, countries started from fundamentally different circumstances and with varying degrees of support and engagement on public sector reform from political leaders (Lindquist, 2000; Halligan, 2001, 2007). Not surprisingly, this affected the mix, pacing and overall coherence of reform initiatives. The explanations for these differences include variations in government or state traditions, the priority and interest that governments attached to what Barzelay (2001) refers to as 'public management policy', the substantive policy challenges and goals confronting governments, capabilities, and the actions of other countries functioning as exemplars or points of reference.
- NPM is best understood not as a coherent, integrated programme of reform (Aucoin, 1995; Charih and Daniels, 1997), but as a family of ideas or a collection of

aspirations, instruments and approaches (Barzelay, 2001; Christensen et al., 2007).[4] These include, for example, a focus on achieving desired results, separating policy capabilities from operations, a focus on service and a customer orientation, providing budget and financial management tools such as accrual accounting systems, increasing flexibility for managers, fostering innovation, encouraging political direction and oversight, using contracts and performance agreements, instituting more competitive appointment regimes, adopting performance regimes, etc. These ideas and approaches can be contradictory (e.g. responsiveness might come at the expense of efficiency, special purpose entities come at the expense of client-oriented service, etc.).

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In short, there have been several streams and variants of NPM initiatives and thinking, and, perhaps to make an obvious point, it is this very diversity that has allowed different governments to design and pace management reform initiatives in unique combinations consistent with existing governance traditions and appetites for reform.

In post-deficit governance environments, with governments in a better position to invest in new policies, greater premium has been attached to improving service to citizens and to the performance of government funding – there is simply less room for governments to cut back services and more incentive for improving their quality. Ensuring value for the expenditure of tax dollars remains important in an era of fiscal rationalisation, and, in this context, so too does political and bureaucratic accountability, particularly with respect to making good on the election commitments of governments. Many governments and academic observers have been arguing that the next wave will consist of integrated, horizontal, joined-up and collaborative government, along with more potent central government (UK Cabinet Office, 2000; Hopkins, Couture and Moore, 2001; 2002; Management Advisory Committee, Australia, 2004; Bakvis and Juillet, 2004; Edwards and Langford, 2002; Christensen and Laegreid, 2007; Halligan, 2007; Shergold, 2007). Intriguingly, despite the many different NPM trajectories of different countries, almost all seem to echo these concerns. However, most of the recent calls for integrated governance, joined-up government and horizontal or collaborative government are aspirations and do not constitute descriptions of how public service institutions currently work, even if governments can always point to instances or initiatives worth of note.

Many public servants I meet who work in different jurisdictions, while well aware of these calls and ambitions, describe a world where silos prevail due to incentives, vertical lines of accountability, and lack of resources and time for boundary-spanning activity. They would argue that, even if they agree and see the need for horizontal approaches, in their workaday worlds they remain firmly in world of the New Public Management, working hard to implement and maintain a sub-set of those instruments, and continuing to balance them with traditional Westminster expectations of governments (responsiveness to ministers, question period, low tolerance for error when accountability works according to older precepts, etc.). They would see the latest reform ideas as compelling and worthy at one level, but little more than veneer at another (unless they get to lead a central, coordinating secretariat) and hardly likely to form a wave that rolls through and reshapes their workplaces. Indeed, given that NPM styles of reporting persist as a basis for annual reports and estimates of many governments, it is difficult to ascertain how integrative reform has been realised in the work world of public servants, service delivery agents, and those who they are meant to serve.

Looking back, many of the ideas that are centrepieces of the integrative governance perspective were elements of NPM and earlier thinking. Shared services were part of the NPM family of concepts, either through internal, single-window possibilities or by outsourcing to firms specialising in corporate services. Certainly, the notion of multi-level governance and co-provision of services was part of Canada's alternative service delivery thinking in the early 1990s. Can we forget the earlier notions of 'co-production' and 'co-participation' in the design and delivery of public services? The focus on accountability and performance reaches back to the 1970s as part of the policy and public sector reform movements in many jurisdictions.

Looking forward, the drivers for reform will likely come from policy priorities and other imperatives, not across-the-board public management regimes (can we really have all horizontal or integrated governance on all issues?). Indeed, some issues already driving reform over the last few years include the new security environment flowing from the 9/11 attacks and the war on terrorism, economic and weather-related upheavals, public health crises and prevention regimes to ward off or contain epidemics like avian flu, and the steady stream of possibilities afforded by new technologies and the precipitous decline of financial markets and government finances. In Canada, significant shapers of reform include a series of scandals during the early 2000s that led to an onerous federal accountability regime already in need of reform; demographic change which will prompt new ways to lead and organise work in public service institutions (e.g. the British Columbia government believes the public service will decrease by one third over its planning horizon); the fact that across the country First Nations have the fastest growing communities and seek control over their destinies; the previous need to move minerals and other resources, leading to the identification and enhancement of transportation gateways and multi-level governance solutions; and, now, the economic tailspin which is leading even the most conservative governments to find new ways for public sersvants to move funding for infrastructure, however defined, and assistance for various sectors with alacrity.

In short, while there may be a coalescing of interest in integrated governance, it is not clear whether the touted wave is significant in scope or essentially different from the checklist of ideas that we have long had in public sector management. It confirms that we have a multitude of important and often competing ideas and values shaping and informing public management reform initiatives: ideas from Westminster precepts, classical administrative and organisation theory, the public sector reform movements of the 1960s and 1970s, and the New Public Management. It is no wonder that many of the stakeholders of public sector reform might be a bit confused or even cynical.

### Narratives and public sector reform

Public administration practitioners and academics are not alone in having a sense of déjà vu about the values and ideas underpinning the latest waves of reform. Let's consider three very different perspectives. First, in Harkoun and the Sea of Stories (1990) Salman Rushdie imagines a sea filled with snippets and elements of stories that can be picked up by the skilled storyteller to weave and build a new story or narrative for the purposes at hand. Second, most human resource competency frameworks and leadership programmes are strikingly similar in the competencies they address. As a colleague has observed, 'when designing a competency-based professional development programmes, the client will always emphasise three or four competencies, but they are all connected to each other as part of a web. You are focusing on a sub-set for the purposes of design and pulling the others along'. Third, Roe (1993) argued that, in domains with high uncertainty and complexity, policy analysts need to ascertain the positive and anti-narratives swirling around, as well as their logical foundations and degree of completeness, and then try to construct a meta-narrative. There are parallels here, I believe, with the various themes of public sector reform: integration and horizontality may be emphasised, but this does not make irrelevant the rest of the elements of NPM and traditional ideas and values.

There is a common element in the perspectives outlined above: each implies a designer or weaver of a narrative or story for a purpose at hand. Indeed, despite cynicism about the 'next' acronym or corporate initiative (and let's leave it until later to discuss what it takes for new narratives to burst through this cynicism), there is nevertheless a powerful human yearning for coherence and a compass to guide strategy and work. Many of us would argue that it is a responsibility and sometimes an impulse of political and organisational leadership to provide new narratives to engage followers.

Here I am less interested in identifying all the narratives and values underpinning public sector reform, and more in suggesting that public sector reform can be seen as competing narratives about what should be or has been done. This leads one to explore the different motives and vantage points for developing narratives and, by doing so, we can explain in some measure the multiplicity of and dynamics found in debates over directions for public sector reform. These motivates include the following:[5]

> ... we have a multitude of important and often competing ideas and values shaping and informing public management reform initiatives

- governments seeking to establish credibility in the area of public management as one part of the overall image they seek to project, ensuring that the public service is competent in providing advice and implementation, appears under control and accountable as required, and is innovative by international standards;
- top public service leaders seeking to build coherence by providing a picture to the government, public servants and citizens about what capabilities and repertoires it requires to advise governments and manage its renewal, as well as where it has been and where it now stands in these regards;
- reform advocates inside and outside the government and public service seeking to move the organisation in new directions by pointing to failures, lesson-drawing and identifying new models from other jurisdictions, and promoting new frames for understanding issues and possibilities;
- opposition parties, watchdogs and journalists monitoring performance, focusing on error, inefficiency, unresponsiveness, over-promising, inability of public service departments to administer according to the norms and principles espoused by audit agencies, lack of direction from the government and, sometimes, best practices;
- academics, former public servants and think tanks seeking to make sense of reforms (or inability to initiate reforms in response to palpable problems), their internal contradictions, and the ongoing activities and dynamics of public service institutions through description,

comparative analysis, explanation, theory-building, critique and advocacy.

There will be contending perspectives across and within each category on what issues are worthy of debate and potential solutions – a multiplicity of narratives about the quality, priorities and directions that public service institutions should take. Given that public sector institutions are so huge and complex, examining them in aggregate can send mixed messages and constitute a recipe for confusion. Relying only on the narratives of governments and public service leaders can lead to partial pictures of the state of play.

Stepping back, there is a broader narrative to consider. There was general concern and disappointment about the performance of government across the OCED nations by the 1980s in the face of growing deficits and seemingly unresponsive public services. This laid the ground for a more decisive approach by many governments, often leading to significant budget rationalisation and restructuring of programmes. This was a fertile environment for New Public Management ideas, partially informed by perceptions of the superiority of business in grappling with change, and acted on in varying degrees. Given that it took a long time to drift into that mess, Lindquist (1997) suggested that restoring trust or a sense of proportion about the appropriate role and competence of government might be a 20-year proposition. The pendulum will not swing back to where it was, but new notions of public sector roles, approaches to service delivery (Heintzman and Marson, 2005) and engagement with citizens and communities could combine to raise the credibility of government and public sector careers among citizens, particularly younger people. The higher-level discourse, which so easily and often celebrates business practice, may begin to even out.

...the next public sector reform initiative may be less about effecting concrete change inside public service institutions and those they serve, and more about being seen to be introducing reform and part of a larger national and international discussions.

Finally, there are other lenses for making sense of the narratives on public sector reform emanating from sitting governments and public service leadership. These lenses come from a stream of organisation theory literature that emphasises the symbolic and ritual dimensions of organisation life. This concerns not only the use of information but also how organisations alter formal structures and nomenclature to 'align' with larger organisational fields in which they compete, collaborate, or seek to maintain status and reputation (Meyer and Rowan, 1977; Feldman and March, 1981; DiMaggio and Powell, 1983; Greenwood and Hinings, 1996; and Christensen et al., 2007). In this sense, scoping out the next public sector reform initiative may be less about effecting concrete change inside public service institutions and those they serve, and more about being seen to be introducing reform and part of larger national and international discussions. With this in mind, we can see debates and efforts to formulate new strategies as means for:

- showing government and other political leaders that the public service is modern and interested in change;
- indicating to political leaders that the public service can self-reform and securing broad support for, but not too detailed engagement in, reform initiatives;
- demonstrating cohesion across complex and often disaggregated and loosely-coupled multi-organisational public service systems;
- shaping values and providing a sense of proportion, making sense of recent history and complexities, and demonstrating continuity while embracing change;
- promoting pride and recognition in public service institutions, retaining top talent, and attracting new talent;
- developing new narratives and initiatives for engaging counterparts in other jurisdictions bilaterally or multilaterally for prestige and higher-level lesson-drawing; and
- engaging, mimicking, adapting and aligning with the most promising ideas and practices of exemplar and selected referent organisations.

These are not cynical observations: not only do government and public service leaders have an incentive to promulgate new reforms, they have special meaning and purpose in the institutional environments of complex public service systems, with many organisations collectively serving elected governments in different ways. Indeed, it is critically important for institutional leaders to engage in such activity for these very reasons.

However, the flip side of this literature is often ignored: such institutional alignment – in terms of either top structures, announcements or nomenclature – can lead to *de-coupling* of announced initiatives from the technical core of organisations. In other words, what the organisation projects is aligned or rationalised, but it becomes 'myth' if it does not run through the organisation. At worst, such strategies can 'buffer' technical cores while maintaining good external reputation. This also raises the possibility, then, that narratives and latest candidates and themes for reform initiatives can be out of synch with organisational realities. The next section considers how we capture those realities.

#### How is government working? Can we ascertain contours and reach?

Before going further, it is worth reiterating that the writing on institutional isomorphism and formal structure as rationalised myth is one strand of an incredibly diverse literature on organisations. Indeed, that strand arose to counter ecological perspectives depicting the environments of organisations as 'selecting' certain structures and approaches (Hannan and Freeman, 1977), and other perspectives that cast the formal structure of organisations as solutions to coordinating the task-structures and relationships among work units comprising the organisation (e.g. Thompson, 1967). Subsequent work suggested that the top-down and bottom-up processes could be working simultaneously (Meyer, Scott and Deal, 1983), but the conclusion that the 'technical core' could be de-coupled, at least partially, from the formal and symbolic undertakings of the 'executive' remains an important insight.[6] This suggests that one way to sort out the effectiveness of previous reform initiatives, as well as of better understanding where organisations stand before reforms, requires appreciating their structure at different points in time.

This seems an easy undertaking – after all, programmes and tasks are what organisations do. But one by-product of the NPM focus on performance, which now affects how many governments report on programmes, has been a relatively narrow focus on outputs and outcomes at the expense of more detailed reporting on inputs and activities. High-level figures are provided on inputs, and many reports seem designed to showcase outputs and sometimes outcomes of government programmes. These reports are not only difficult for non-experts to follow on a year-over-year basis, but, more importantly, the level of aggregation is usually quite high, making it difficult for readers to get a good sense of how *specific programmes* work, how many people work in them, and what the precise allocation of resources was for this purpose. And, whatever the merits of accrual accounting from a resource allocation perspective, when combined with a focus on outputs and outcomes this makes more opaque the allocations for specific programmes; only experienced officials can fruitfully read between the lines.

Not surprisingly, it is difficult for observers who try to get underneath the high-level announcements and rhetoric to determine the effect of public reform initiatives. Guiding questions might include: how have the contours of government, departments and specific programmes changed over the years? What is the value-for-money of certain performance levels given resource levels? How well organised are the activities comprising specific programme areas? Auditors-general, of course, try to provide answers to some of the questions, but often this proceeds from a narrow mandate and an accounting perspective, not acknowledging the broader demands on departments and managers, and the emergent quality of public sector work. Rarely do public auditors rely on systematic comparative analysis at this level of detail.

This suggests that finer-grained ways and nomenclature are needed to capture and track the work of governments. One could simply mandate more detailed reporting by government departments, since the information has to be in the system. Or one could rely on detailed academic studies on specific functions, but these take a long time; and there have been some interesting examples (Christensen and Laegried, 2007; James, 2003; Hood et al., 2004). Some of these studies are selective and idiosyncratic, but they do try to join up high-level themes about reform by on-the-ground comparisons across agencies or jurisdictions.

A third possibility would be to establish a database and taxonomy for categorising and tracking the work of public organisations. Lindquist (1992) reviewed the literature on organisational taxonomies with this latter idea in mind. Even then, though, there was little take-up of earlier efforts to establish taxonomies or of McKelvey's seminal *Organizational Systematics* (1982), owing to the literature's early focus on informing empirical analyses of assorted organisational variables, and later on developing taxonomies as part of the population ecology movement. No one saw the potential role of organisational taxonomy in the sense discussed here: to categorise and monitor the evolution of specific programmes and their 'comp pools' over time and, by implication, which areas were embraced by specific portfolios. To be sure, one cannot understand the evolution of specific programmes without appreciating institutional direction, culture, history and capabilities, but, conversely, we need to get far better at understanding capabilities and innovation from a bottom-up perspective. One could probe assertions about the benefits ascribed to different governance regimes: is it true, for example, that jurisdictions adopting policy–operations splits under NPM have less policy capability than those jurisdictions that did not? Do certain programmes that appeared effective still seem so when compared to other jurisdictions?

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Such a strategy would not address the important matter of assessing the evolving 'reach' of government through specific programmes. To do this requires going beyond ascertaining the activities and levels of staffing and financial resources to capture the instruments utilised by government bureaux to influence other governments, citizens, organisations, etc. So, for example, a programme area might well decline dramatically in staff size and budget, but oversee a devolved capability such as a service delivery network or public–private partnership. Developing indicators need to be informed by the perspectives of markets, hierarchies and networks (Powell, 1990). Making such assessments is essential for multi-level governance and collaborative environments across jurisdictions.

Proceeding with such a proposal would be a significant enterprise, involving public servants and academics alike, focusing on certain broad functions (i.e. social service programmes) as a point of departure, and working across countries on a networked basis. However, my main purpose here is not to make a formal proposal for developing a taxonomic classification system for public organisations. Rather, I am suggesting that we don't have very good information on the contours and reach of programmes, which creates more room for competing narratives about the progress and possibilities for public sector reform. Institutional themes and narratives will tend to trump programme-level perspectives.

... governments have worked hard and made huge investments to apply ICTs to the delivery and re-design of services and to collect information,

**An overlooked opportunity: creatively conveying government**

The previous section argued that governments are typically not good at capturing how government programmes evolve over the longer term with respect to how they work and their reach. I would like to suggest that, even if we were collecting that information, we would have difficulty conveying that information to citizens, their elected representatives, and interested observers. Indeed, the next frontier in public management reform might have less to do with what direction it takes (and, yes, there will be labels, acronyms, and overlap with previous initiatives), and more to do with finding novel and interesting ways to convey what it takes to mobilise effort and accomplish associated objectives.

One premise behind NPM and its seeming successor – integrated governance – was that information and communications technology (ICTs) will provide the necessary back-room support and interface software to allow for better service to be provided and for governments to mobilise better across programme boundaries (Borins et al., 2007). Great strides have been made using ICTs and, even though many in the shared services and technology functions of government might believe progress has been too slow with respect to the pace of investments and achieving full integration, the potential remains. However, if one steps back to look more broadly at the directions in which ICTs have gone, we can see that the public sector has failed to explore the potential for animation and graphics technologies for better showcasing how government programmes work.

A review of any annual report or estimates document of a government department or agency should be sufficient to make this point. I grant that many such documents often use fancy graphics and photographs to make key points. However, such documents do not convey succinctly the complexity of how government programmes work, what it takes to mobilise effort within and across governments, what sort of clients a programme is trying to reach, and how all of this works spatially and over time. As noted above, public reporting on the 'guts' of government has declined in the name of a focus on results. Indeed, governments seem to take pride in making themselves less difficult for citizens to understand, an admirable instinct at one level, but this buffers citizens from understanding the complexity, volume and pressures associated with providing the services they receive. In short, it is increasingly difficult for outsiders – whether elected representatives, citizens and stakeholder groups, or academic observers – to ascertain how government is organised and what resources are mobilised to produce programmes, outputs and results. At a recent roundtable on 'Improving Government Accountability' hosted by Victoria University's School of Public Administration, some participants observed that the 'linear and text-based' reporting of governments is out of synch with what younger generations require for engagement, and for many of us too.

We could imagine a different sensibility. The Sunday *New York Times* often contains graphic renderings of background information for a topic of special interest in its 'Week in Review' section. One encounters amazing efforts to convey a large amount of information in a succinct way, but done so as to capture the complexity and provide a sense of proportion. Another prime example is Tufte's *Envisioning Information* (1990) and subsequent books.[7] Over the last 20 years Tufte has dedicated himself to finding interesting ways to convey information in intriguing and, frankly, beautiful ways. I also recall happening on booths advertising graphics design schools in Federal Plaza in Melbourne a couple of years ago and realising that the professions of architecture and graphics design have used ICTs for years to provide renderings of complex buildings and public space, showing how they relate to users in manifold ways. There has been a missed opportunity: governments have worked hard and made huge investments to apply ICTs to the delivery and re-design of services and to collect information, but, despite the amazing progress and incredible potential in graphics technology, governments have not made parallel investments for the purposes of conveying the complexities of public service institutions more generally, nor the intricacies of coordinating and reaching out to deliver particular services more specifically.

The possibilities for applying ICTs to conveying the complexity of government work seem boundless and exciting. The question here is not whether it can be done, but whether public institutions will take up the opportunity. Moving in this direction would marry hitherto separate domains: public management innovation and citizen/legislator engagement. Government consultations could be more productive and meaningful if background documents conveyed the current nature of programmes and how they intersect with partners and recipients. When specific instances of error or questions about the performance of government departments arise, a broader perspective on programmes (size, number of transactions, reach, etc.) could put issues in perspective. There would be gains in briefing policy makers and would-be partners on initiatives. And, if done well, it would show how the contours and reach of government had been evolving over time.

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1 This article was prepared for a conference on 'After the Reforms: Where Are We Now? Where Are We Headed?', hosted by Victoria University of Wellington's School of Government and the Institute of Public Administration of New Zealand, 28-29 February 2008. The title of the article plays off Tom Flanagan's book *Waiting for the Wave* (1995), which analysed how Canada's Reform Party was positioning itself to take power in Ottawa.

2 This writing from a productive set of colleagues (Christensen et al., 2007a) is only tapping into part of a much broader literature on organisations, and there are other currents that would be of greater interest to practitioners and point to a pragmatic research and action agenda.

3 Halligan (2001) shows how different Anglo-American countries had handled reforms over the last 20 years. Considerably more analysis of continental European models has been recently undertaken in the English literature (e.g. Christensen and Laegreid, 2007; Pollitt and Bouckaert, 2nd edition, 2004), showing that many countries have long operated on a decentralised basis, and, though not early adopters, have more recently embraced some New Public Management ideas.

4 Christensen et al. (2007, p.128) write that NPM is 'not a consistent and integrated theory for modernizing the pubic sector, but is better characterized as a wave of reforms composed of some principle reform ideas together with a loose cluster of reform initiatives pointing in various directions'.

5 This list is expanded and adapted from Lindquist (2006). Its purpose was to create a rendering of the 'Canadian model' of public service. There had been a considerable amount of ink spilled on the Canadian model, although much of the writing, interestingly enough, was not about the public service *per se* and more about various facets of the governance system. Because of the way the debate had evolved, there were different motivations and positions from which ideas about models or narratives were generated.

6 We know that hierarchy, attenuated communications, capacity and other priorities create similar gaps.

7 For further information on Tufte's other publications, visit the website http://www.edwardtufte.com/tufte/.

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Martin Lodge

# Strained or Broken? The Future(s) of the Public Service Bargain

Over 60 years ago the first political science professor at Wellington's Victoria University, Leslie Lipson, noted in his 1948 *The Politics of Equality* that:

> With the political parties the modern [New Zealand] civil service has struck a mutually beneficial bargain. By guaranteeing to public servants a life's career and a pension, parties have foresworn the use of patronage and have guaranteed to the state's employees their tenure of their jobs. In return the parties expect, and the public servants owe, equal loyalty to any government which the people have placed in office. (Lipson, 1948, p.479)

A quarter of a century later, Bernard Schaffer defined the 'Public Service Bargain' that applied to Whitehall civil servants in broadly similar terms. For Schaffer, in return for agreeing to 'anonymity, some sacrifice of political rights and proficient performance', British civil servants were assured 'prominent careers, honours and a six-hour working day when the middle classes wanted just that, and neutrality was possible, credible and inexpensive'. Schaffer suggested how the Whitehall model of a competent, neutral and serially loyal civil service was underpinned by 'some quite peculiar conditions and, as it were, a highly complicated bargain'. Given the nature of the 'highly complicated bargain', Schaffer also noted the incentive of the various parties to 'shuffle out' of their (usually implicit) obligations under the Bargain (Schaffer, 1973, p.252).

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In the late noughties of the 21st century, there is little to suggest that the Bargain is still regarded as 'mutually beneficial'. While Lipson and Schaffer would still recognise the idea of serial loyalty in both the New Zealand and UK systems, the reward side of the Bargain has changed considerably, in particular in New Zealand. Drawing on experiences across different national systems, one can point to at least three dimensions under which the Bargain seems to be under strain across different jurisdictions and different state traditions:

- On the reward side, public servants criticise the fact that they were asked to turn away from the tenured life of material security with the promise of adequate material compensation for the heightened risk premium. They note how they have been left behind in an ever-increasing pay differential in comparison with the top of the private sector. This cheating on the material side of the Bargain was made official with the move, in both New Zealand and the UK, to make material reward no longer market-facing, but wider public service-facing. At the same time, critical voices point to unclear assessment and promotion criteria and low guarantees of reward for outstanding performance. On the other side of the Bargain, politicians moan about the risk-averse nature of public servants and the lack of performance management systems to make public servants responsive.
- On the competency side, public servants across countries complain about being shouldered aside by new generations of political advisers, especially at the centre of government. Gone are the days in which public servants could claim monopoly status as sages and policy wonks in government. Instead, life at the top of the civil service has increasingly meant attention to organisational detail and 'delivery', somewhat disheartening if the main attraction of a civil service career was being at the heart of decision making. On the other side, politicians, faced by laptop and USB memory stick losses, failures in

social security payments or procurement of information technologies, or the publication of embarrassing details on government websites, suggest that competence in the context of bureaucracy is, at best, a misnomer. They point to the lack of bureaucratic responsiveness to the political demands of a 24/7 media landscape and the need to govern through well-targeted leaking. Critical of the advisory and delivery skills of their civil servants or the particularly 'econocratic' nature of policy advice, they ask for more 'delivery' skills of their administrative machine, while looking for expertise on substance and presentation elsewhere.

- On the loyalty side the bargain is under pressure too. Whereas in the past, public servants would assume that ministers would take the flack for decisions, in the contemporary world civil servants are outed and publicly criticised, without public servants having the formal right to respond. On the other side of the bargain, politicians are openly dismissive not just of the idea of 'serial loyalty', and suspect 'disloyalty' on the side of their public servants.

As with all relationships, the rules of engagement are only to some extent written down, but are also based on implicit assumptions and conventions.

Such views are particularly prominent among politicians who have spent considerable time on opposition benches, as was observed in New Zealand post-1999 or Germany after the election of the Social Democrat–Green coalition in 1998. In Canada, too, the government of John Harper was seen as openly questioning the loyalty of the civil servants, with headlines suggesting that 'Harper sees a liberal under every federal bed' (*Globe and Mail*, 19 January 2006, p.A18).[1] But the scepticism regarding the loyalty of civil servants goes much further. For example, David Blunkett in his diaries of his time as a Cabinet minister during the Blair administration noted that 'we have a situation in my department where virtually anything of any importance is leaked … The civil service are very lucky that we can't sack them, that no one can sack them' (Guardian, 13 October 2006, diary entry for February 2002). Even more publicly, Gordon Brown, just before his move to 10 Downing Street, was condemned by a former Cabinet Secretary as having 'Stalinist ruthlessness' and a 'Macavity quality. He is nowhere when there is dirty work to be done' (*Financial Times*, 20 March 2007).

After over two decades of administrative reform, the 'mutually beneficial bargain' has not only changed, but also appears to be in considerable trouble, way beyond the usual boundary-policing issues about what are partisan political or government activities. Something more significant seems to have happened to Schaffer's 'peculiar conditions' that made the operation of traditional Public Service Bargains possible. Public Service Bargains set out the terms of the relationship between public servants and the wider political system, especially with politicians. As with all relationships, the rules of engagement are only to some extent written down, but are also based on implicit assumptions and conventions. Consequently, where to draw the line between the 'appropriate' and the 'inappropriate' often remains unknown, unless one has overstepped that boundary. Furthermore, these boundary lines are subject to changing interpretations (see Hood and Lodge, 2006). Much has been written about how we got here, but what is the future direction of travel?

### What future for the Public Service Bargain(s)?

New Zealand is widely regarded as a prominent case of administrative reform, having moved to a system in which the public servant's 'life's career and pension' are no longer guaranteed, but where the 'serial loyalty' understanding of enthusiastic work for the government of the day has remained. Furthermore, the wider rules of the game have changed, in particular with the introduction of MMP in 1996. So what is the future of the Public Service Bargain? How can the Public Service Bargain be made 'fit for purpose for the 21st century', a phrase so commonly used by those involved in UK civil service reform debates?

One option, the 'back to the future' option of returning to 'constitutional principles' and regarding the last decade of increased boundary testing by politicians as a deviation that requires correction, seems problematic. On the one hand, in particular in the case of New Zealand, this raises the question of which 'back to the future' states of the world these critics aspire to: first, whether this applies to the world of pre-MMP or not; and, second, whether their prescription applies to the world of the 1912 Public Service Act that was at the heart of Lipson's account, or the 'pure' world of the 1988 reforms that maintained serial loyalty, but radically changed the reward side of the Bargain. Politics (especially post-MMP) and society have arguably moved on, thereby changing the 'quite peculiar conditions' that allowed for the endurance of traditional Bargains. For example, in the UK, devolution has changed the context in which a unified civil service for all the territories of Great Britain operates, even though contemporary debates do their best to ignore this issue.

Another option would be to do nothing. Bargains might have sufficient self-healing capacities. Should one party to the Bargain stray too far from the explicit and implicit understandings, the other party will respond. For example, attacks on the competency and loyalty of civil servants will be answered by a range of responses, ranging from increasingly risk-averse policy advice and implementation to the discrete dissemination of inconvenient details regarding ministerial decisions. Arguably, both parties, when faced by the abyss of a complete breakdown in their relationship, will come to their senses and return to 'working relationships'. Such processes can even be observed in the case of former ministers. For example, when the former UK trade minister Lord (Digby) Jones reflected about his 'dehumanising' experience as junior minister, he suggested that half of the civil service should be sacked. He later retracted this statement (following audible civil service disgruntlement), calling for a 'more rigorous analysis' of civil service numbers and suggesting that he had not meant to attack the civil servants working directly under him in his portfolio, but those operating elsewhere in the Department for Business, Enterprise and Regulatory Reform (causing further offence) (*Financial Times*, 28 January 2009).

The 'do nothing' option will also appeal to those who believe that the benefits of any change will be outweighed by the costs of unintended side-effects. Nevertheless, a 'do nothing' alternative is unappealing to those who are looking for ways to improve the workings of the Public Service Bargain and who argue that the balance of power between blame-avoiding politicians and powerless civil servants does not allow for equilibrating tendencies.

So if 'back to the future' is hardly an option as society and political systems have moved on, and the 'do nothing' option is arguably not viable, what other options are left? The rest of this short paper presents three dominant reform scenarios. Each has implications for understandings that relate to three dimensions of any Public Service Bargain, namely rewards, competencies and loyalty. This selection of scenarios is not meant to provide a fully exhaustive or mutually exclusive account, but it does cover three main branches of contemporary public management debates. Each scenario seeks to draw out differences rather than commonalities to animate discussion. If each of the three scenarios has some currency and relevance for the future of the Bargain, then this suggests that there will hardly be 'one' Bargain for the future as there is no one single 'modern' form of bureaucracy of the future. Instead, there will be ongoing complexification and diversification, with all the scope for 'misunderstandings' that these cause. Indeed, each one of these three scenarios generates its own opportunities for the different parties to 'shuffle out' of their assumed obligations under the Bargain.

#### *The 'managerialist state' Public Service Bargain*

This narrative diagnoses the key problems in contemporary arrangements as a lack of 'managerial' thinking that permeates both political and bureaucratic worlds and produces inefficiency. Consequently, incentives need to be high-powered and well-designed, the autonomy space well demarcated and emphasis placed on 'managerialist' skills and capabilities to run organisations.

This is to some extent a 'back to the future' to the ambitions of the State Sector Act of 1988 and the Public Finance Act of 1989. That is, the bargain provides for a greater scope of managerial autonomy for public managers to deliver against mutually agreed benchmarks (i.e. outputs and, possibly, outcomes). High material rewards await those who achieve these targets. Far less reward, if not unemployment, awaits those who fail to deliver. It is a world where stable career expectations are replaced by an explicit 'up or out' management system. To achieve those performance targets, skills and capabilities to 'deliver' are required with clear differences between those bureaucratic activities that are concentrated more on the policy and those on the more managerial side (for example, human resource, project or financial management side). Against those who argue that 'policy wonks' and 'sages' within government are unlikely to enthusiastically endorse 'delivery', this account suggests that 'one more heave' at designing better incentive systems will deal with these problems. Similarly, incentives are seen to encourage collaboration among government departments rather than merely specialisation and fragmentation.

In terms of loyalty understandings, the managerialist bargain requires 'obedience' rather than loyalty.

In terms of loyalty understandings, the managerialist bargain requires 'obedience' rather than loyalty. In other words, public servants are instructed to deliver (unquestioningly) and are visible to the outside world in terms of being responsible for delivery. Thus, loyalty is understood as 'requirement to deliver' and being 'free to manage' to do so.

#### *The 'regulatory state' Public Service Bargain*

According to this narrative, the key problem affecting politics is discretion. Public servants 'bureau-shape', 'budget-maximise' and filter out those activities they dislike. Politicians similarly are accused of pork-barrelling and of responding to incidents in the style of Pavlov's dogs in order to receive short-term applause from their constituencies. These instincts are further accentuated by performance-oriented civil servants who seek to please their political masters.

The cure therefore is to juridify the relationship between public servants and politicians in the way in which central banks or regulatory agencies have been made 'independent' over the past two decades to take the political 'time inconsistency' problem out of particular policy domains, while the risk of 'administrative expropriation' is reduced through legal procedural devices and focused rather than general oversight. Accordingly, this would produce a vision of ever more contractualisation within government, accompanied by an army of watchdogs, waste-watchers and other oversight bodies, thereby extending previous attempts at writing down relationships across various parts of the state to ever more aspects. One example of such an initiative was the announcement, in late January 2009, by the UK shadow chancellor of the exchequer, George Osborne, that, if elected, a Conservative government would seek to turn the 'Whitehall supertanker' by imposing on senior civil servants a 'fiduciary duty' towards taxpayers to ensure value for money.

If this scenario were to be realised, Public Service Bargains would resemble those that apply to central bankers and regulators. In other words, reward would be defined in strict terms and not be related to the political preferences and priorities of the government of the day, but would be determined in ways that were not sensitive to political feelings and opinion poll standings. In terms of competency, too, the bargain would look very distinct, namely with a very strong emphasis on 'policy wonk' characteristics, as expert judgement is brought to bear on different policy problems and constellations. Finally, in terms of loyalty understandings, this Bargain would move away from traditional 'serial loyalty' (or monogamy) understandings that have been common in Whitehall and Wellington and towards a more 'trustee'-type role in which loyalty is paid to specific constitutional values and obligations. For example, in competition law it is widely the case that those judging cases are to be solely directed by the law rather than by the political context of their decision. Such regulatory Bargains would also require an institution to judge the decisions by civil servants, as well as an appeal system.

The future of the Public Service Bargain may therefore lie in the multiplication of Bargains rather than a convergence into any one particular 'paradigm'.

***The 'governance state' Public Service Bargain***

While governance has come to mean many things, the term is used here to highlight the intermeshing of private and public spheres of influence. In other words, authority is shared across different actors. Core aspects of the 'governance state' are the sharing of authority and the importance of participation, co-governing and negotiation. Delivery of outcomes is not achieved through hierarchy alone but is dependent on third parties: i.e. delivery occurs through 'networks'. The governance state, defined in these terms, is about increasing complexity and disputed hierarchy.

In the case of New Zealand, realisation of such a 'governance state' would require a full endorsement of the underlying ideas of MMP rather then begrudging acceptance by major party politicians, eager to present themselves in presidential or chief executive terms, and by civil servants, discontent with having to see their 'pure' policy ideas filtered by negotiation between coalition party committees.

Such a world of a 'governance state' raises considerable problems for a performance-oriented reward system as outcomes, if not outputs as well, are largely a matter of third party delivery and co-governing. For competency, the key aspects here are those that have been termed 'boundary-spanning' skills, namely not the skill to be 'best in the world' in terms of in-house expertise or in terms of providing political tactical advice to ministers, but the ability to bridge and access differentiated social systems, to 'translate' their different demands and to bring these systems together through negotiated settlements. Such settlements also raise distinct issues for loyalty understandings, as the demands of long-term problem solving within policy domains conflict with traditional ideas of 'serial loyalty' to ministerial hierarchy, a problem that also applies, for example, to national diplomats dealing in international negotiations.

**'Shuffling out' of the Bargain**

If the Public Service Bargains look remarkably different under the three different 'states', then there are also very different ways in which the three Bargains can become unstuck by either party seeking to shuffle out. In other words, none of the three scenarios is likely to provide any stability as the diverse parties have different incentives to cheat.

Under the 'managerialist state' scenario, the terms of the Bargain are that of a 'thermostat'. Politicians choose the desired outcomes and outputs and bureaucrats are free to choose the interventions required to achieve these agreed targets. However, such a 'thermostat' vision of a Bargain is vulnerable on several counts. For one, it is vulnerable to the question of whether performance is really being assessed on the agreed targets (regardless of whether they are meaningful indicators of 'quality' or not), or whether managers are 'free to manage' or must suffer considerable political background intervention in their activities. Furthermore, it requires rather heroic assumptions as to behavioural implications for the manager of the fear of non-achievement. For example, likely responses to such a regime range from 'creative compliance' responses ('hitting the target, but missing the point') to open manipulation of information.

Under the 'regulatory state' scenario, ideas about juridifying relationships seek to reduce 'cheating' on the bargain, or to make the consequences more explicit. However, it is unlikely that this Bargain variant is without its opportunities for 'shuffling out' behaviours. On the political side, politicians are tempted to dispute jurisdiction (branding a 'decision' as 'advice', for example), to launch political whispering campaigns doubting the intellectual or mental capabilities of their civil servants, or simply to bypass public servants through direct negotiations with constituencies. On the public servant side of the Bargain, shuffling out would be characterised by creative interpretation of objectives through activist decision making or in terms of non-expert decision making (for example, due to 'capture'). Such Bargains will become strained when ministers are told to purchase military hardware for half the price from elsewhere at the expense of domestic industry. [2]

In the world of the 'governance state', problems of shuffling out are also likely to occur. On the political side this links to the acceptance of co-sharing and negotiated power instead of asserting hierarchy, as well as showing little interest in including key societal actors in negotiations. On the bureaucratic side of the 'governance bargain', shuffling out is characterised by showing little interest in comprehensive boundary-spanning and by lacking competence in negotiating and compromising within networks.

**What next?**

The discussion of the different scenarios for a future Public Service Bargain was meant to point to discussions regarding the nature of governing in the contemporary state and to derive some implications for discussions regarding the evolution of the Public Service Bargain. The intention was neither to condemn the past decades of 'New Public Management', nor to diagnose any particular problems in the case of New Zealand and offer solutions. Instead, the intention was to build on cross-national observations to encourage debate regarding the future direction of Public Service Bargains. One of the advantages of looking at administrative reform ideas through the lens of the Public Service Bargain is that it strengthens awareness that any intended action leads to reactive behaviours on both sides of the Bargain (i.e. 'it takes two to tango'), thereby highlighting the importance of strategic adjustments to demands and challenges.

The various scenarios or narratives point to diverse, partly reinforcing, partly countervailing dynamics that are at the heart of contemporary governing. The three scenarios suggest different relationships between politicians and public servants. There are also significant differences in the understanding of reward, competency and loyalty. Therefore, it is unlikely that the future will be characterised by any one 'mutually beneficial bargain'. The future of the Public Service Bargain may therefore lie in the multiplication of Bargains rather than a convergence into any one particular 'paradigm'. Accordingly, different Public Service Bargains would explicitly operate side by side, with considerable overlap, also especially with those Bargains that apply to political advisers (who have not been considered here).

Multiplication and diversification should not, however, be confused with a reduced centrality of Public Service Bargains within executive government. Although ideas regarding national stereotypes of one single 'Public Service Bargain' may require reconsideration, the underlying analytical ideas are arguably more critical than ever in order to understand the relationship between public servants and the wider political system. That is, expectations regarding rewards, competency and loyalty remain central in executive government, although how these expectations are constituted will increasingly depend on individual location within the executive. The value of the Public Service Bargain idea is that it is able to offer a fine-grained perspective on individual Public Service Bargains as an exchange relationship with the wider political system, and puts the emphasis in the study of reform in executive government on the effect on relationships rather than on announcements.

In sum, the future of the Public Service Bargain is unlikely to be uniform, and it is also unlikely to be stable. Multiplication makes sense if it is accepted that varied demands on the state require a varied response by the state. Such multiplication, however, also brings with it considerable scope for confusion and misunderstandings, along with the inherent tendencies within individual Public Service Bargains for one or more parties to shuffle out. Rules and constitutions are unlikely to deal with such shuffling out; instead, such behaviour can only be somewhat contained through shared understandings and conventions. However, such shared agreements require highly peculiar conditions, and it is questionable how feasible or durable such conditions can be in a world of an increasingly heterogeneous public service, and blame-avoiding politics in which politicians are said to feel permanently under siege.

1 Two years later, the *Ottawa Citizen* headlined a story: 'Hostility between politicians and PS hits new high, adviser says' (23 February 2008).

2 One example of such strain emerged in late January 2009 in the UK. The cost of a new national computer system for the National Health Service had increased sevenfold to £13bn. It was alleged that civil servants chose not to follow appropriate cost-benefit procedures at the outset of the scheme in order not to embarrass a prime-ministerial flagship announcement by indicating that costs were likely to outweigh benefits (*Financial Times*, 28 January 2009).

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Brenda K. Bushouse

# The 20 Hours (Free) Programme

## Important Choices Ahead for New Zealand's New Government

The 20 Hours Free programme was implemented in July 2007 after having been one of three new education policies announced in the Labour Party's 2005 election manifesto. The new programme was the brainchild of Education Minister Trevor Mallard and provided 20 hours of government-funded early childhood education (ECE) for all three and four year olds, regardless of family income. When the Free ECE programme began, participation was large enough to affect the Consumer Price Index: 'Education prices fell 5.2 percent [for the September quarter], due to lower prices for early childhood education as a result of changes to government funding' (Statistics New Zealand, 2007). The most recent data indicate that 86% of eligible services participate and 93% of eligible children participate (Ministry of Education, 2008). With its tremendous success, the 20 Hours Free ECE programme has become the biggest, most expensive early education programme in the country. September 2008 data indicated that the government had spent over half a billion dollars on the programme since its inception, and that it accounted for approximately 70% of the $807 million Vote Education early childhood education budget for 2007-08 (ibid.; New Zealand Treasury, 2008).[1] An additional $90 million was added to the early childhood education budget for the 2008-09 fiscal year.[2]

With the 2008 election, the National Party could have decided it would reign in spending on the new programme, but instead it chose to call for its expansion. The National Party's manifesto promised to expand eligibility to more services and to allow five year olds to participate. While this was politically expedient, National is now faced with the budgetary increases that will result from expanding access to the popular programme. This article provides a brief history of the development of the programme, a discussion of the wedge issues that arose, and an assessment of three policy options available to the government.

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### History of the 20 Hours Free programme

The success of the programme makes it easy to forget how controversial it was to create 20 Hours Free. After the inclusion of the new programme in the 2005 Labour manifesto, three issues arose: opposition to the exclusion of private services, opposition to the exclusion of parent/whānau-led services, and a restriction on 'top-up' fees. Only the first issue was resolved by the Labour Government. The other two developed into wedge issues, one of which the National Party resolved with the expansion of the programme to parent/whānau-led programmes in its 2008 manifesto. But the issue of 'top up' fees remains an important policy issue for National to consider.

Prior to the 20 Hours Free programme, the government already provided universal subsidies to all early childhood education services for up to 30 hours per week for each child from zero to five years of age. In addition, the Ministry of Social Development provided subsidies for up to 50 hours per week of child care for qualifying families. The 20 Hours Free programme was a stark departure from previous early childhood policies because (1) it limited participation to teacher/kaiako-led services, and (2) it marked a shift in funding policy from a subsidy to covering the entire cost of early education. Unlike the subsidy programmes, under which services could 'top up' the subsidy with parent fees, the 20 Hours Free programme prohibits top-up fees in exchange for providing a higher level of funding set to cover the average cost of care at the regulated quality level.

When the Ministry of Education was developing the proposal that ultimately became the 20 Hours Free programme, Minister of Education Trevor Mallard was firmly committed to universal access to free early childhood education in community-based services (Mallard, 2008). He believed that community-based services could expand to meet the demand; however, nearly a third of all ECE enrolments were in privately-owned centres (see Table 1) and a backlash ensued. Despite Mallard's commitment to community-based provision, the political opposition in the lead up to the 2005 election was too great to sustain the exclusion of private services and ultimately they were allowed to participate. On a pragmatic level, expansion to private services increased the number of services that could potentially offer Free ECE by around half and thereby reduced the risk of a shortage of Free ECE spaces (Minister of Education, 2006).

The parent/whānau-led exclusion was a particularly sensitive issue because in 2002 the Ministry of Education began implementation of its strategic plan for ECE that committed the government to improving the quality of early childhood education. One of the major parts of the strategic plan was to raise ECE quality by increasing the educational level of teachers and by providing an incentive to hire more qualified teachers through the linkage of reimbursement rates to the number of qualified teachers. Both Playcentre and Te Kōhanga Reo objected to the assumption that teacher qualifications equate with quality of care and countered that there are many pathways to quality (Pilkington, 2008, Tangaere, 2008). Both the Playcentre Federation and Te Kōhanga Reo National Trust wanted to participate in Free ECE, but they did not want to change aspects of their programmes that they felt were fundamental to their philosophies. Playcentres (9% of enrolments) are unique within the sector in that they are co-operatively managed and supervised by parents with support from experienced personnel in the 33 regional Playcentre associations under the Playcentre Federation. They provide sessional programmes for children from birth to school age in mixed-aged environments. Currently there are 466 licensed and 22 unlicensed Playcentres (Ministry of Education, 2007). Te Kōhanga Reo, literally translated as 'language nests', are designed to maintain te reo Māori by introducing children from birth to the Māori language and culture. Currently there are 470 licensed Kōhanga Reo accounting for 5% of total enrolment in ECE (see Tables 1 and 2). The Playcentre Federation and Te Kōhanga Reo National Trust wanted the recognition, expressed in policy, that there are multiple pathways to quality and, on that basis, participation in Free ECE. But the Labour government maintained the exclusion of parent/whānau-led services from participation in the 20 Hours Free programme. The National Party promise to reverse this policy by expanding eligibility to parent/whānau-led ECE services in its 2008 manifesto.

The final wedge issue, top-up fees, endures and presents the government with a choice of maintaining the paradigmatic shift to universal access or reverting to the subsidy approach of the past. However, the history of this issue is worth revisiting because it is likely to affect the reaction of the sector to the new government's policy decisions. Shortly before the 2005 election Steve Maharey was appointed minister of education, and he noted that the expansion to include private providers in Free ECE would increase the cost, and that it could also increase the risk that the price paid for free provision would not be seen as adequate. He was right on both counts. The Ministry of Education estimated that the Labour Party manifesto commitment would cost $148 million over the 2007–2010 budget cycle (Minister of Education, 2006). That led the media and the ECE sector to focus their attention on determining the funding rates. Early on in the development of the Free ECE programme, the ministry advised Cabinet to fund Free ECE based on average costs for meeting licensing standards without charging parents. Ministry of Education staff advised then minister Trevor Mallard that funding based on average cost would not cover all the costs of every service. They advised that the proposal would need to be carefully positioned to signal that the funding rate would not cover all costs, but also to signal that the government would continue to 'subsidise' rather than 'fund' ECE (Minister of Education,

**Table 1: Number of enrolments in early childhood education by type of service, 1995 and 2007**

| TYPE OF SERVICE | 1995 | % of sector | 2007 | % of sector | % Change 1995-2007 |
|---|---|---|---|---|---|
| Kindergarten | 47,208 | 33% | 43,695 | 26% | -8% |
| Playcentre | 19,108 | 14% | 14,664 | 9% | -30% |
| Education and care centres | 53,769 | 38% | 91,733 | 54% | 41% |
| Te Kōhanga Reo | 14,015 | 10% | 9,236 | 5% | -52% |
| Home-based networks | 6,114 | 4% | 11,073 | 6% | 45% |
| Correspondence School | 901 | 1% | 737 | <1% | -22% |
| **TOTAL** | **141,115** | **100%** | **171,138** | **100%** | **18%** |

Source: Adapted from Early Childhood Enrolments Time Series Data, Sheet 7, retrieved from http://www.educationcounts.govt.nz/data_collections/ece_staff_return

2003, section 7a). Ministry staff also warned of significant fiscal risks from a government commitment to meet the costs of the strategic plan. Because the government does not set fees for early childhood services, it would be exposed to claims from services for funding increases. The Ministry staff advised the minister to carefully communicate the proposal to ensure that the government would not necessarily respond to every cost increase, or at least not respond in full (ibid., section 7b). This indeed became a divisive issue in the implementation of the programme.

The Labour-led government's 2006 budget commitments to ECE included not only the new 20 Hours Free programme but also the changes related to the strategic plan. In October 2006 the minister, Steve Maharey, announced that, 'Early childhood centres will be required to have 50 percent qualified teachers in all centres from December next year [2007].' He continued: 'Cabinet has also agreed to improvements to adult to child ratios from 2009' (Maharey, 2006c). With these increased costs for teachers and regulatory changes in the works, the sector became uneasy with the yet-to-be-announced funding levels for Free ECE; however, the 2006 budget included increased funding rates for providers amounting to almost $30 million over four years, to enable the early childhood sector to 'move more rapidly towards its goal of all teachers being registered by 2012' (Maharey, 2006a). The budget provided all-day services with an up to 13% increase and sessional services with an up to 11% increase. The budget also included a 9% increase for Playcentres that was intended to support the cost of administration in order to free volunteers to spend their time with children (Maharey, 2006b).

As Trevor Mallard envisioned, the 20 Hours Free ECE programme is supposed to be free because it is a statement that the government is committed to paying for quality early childhood education for all three and four year olds regardless of a family's ability to pay.

Even with these increases in funding, the controversy over Free ECE funding rates did not decrease. The ministry set the Free ECE rates based on a survey of operating costs conducted in 2005 and 2006 (personal communication, 2008). Typically the rates would have been announced in May 2007 along with the budget, but because of the high-profile controversy over funding rates, the ministry was allowed to release the Free ECE rates on 21 December 2006, a full six months early. The funding scheme reflects a cost-driver approach, with the highest rates provided for ECE services with the highest costs. In this approach all-day, centre-based ECE with 100% registered teachers receives the highest funding rate, and services with sessional programmes, home-based and/or fewer registered teachers receive lower rates. These rates were increased in July 2007 to reflect updated cost data. The commitment of the government was to provide funding to cover the regulated quality level, which necessitates regular adjustments to the funding rates schedule.

The response from the sector to the funding rates ranged from full support to adamant opposition, with many undecided. The New Zealand Childcare Association, a membership and education organisation, immediately voiced its support of the Free ECE programme in a media release. Barnardos New Zealand, responsible for 1,800 enrolled children and half of the home-based providers, announced its participation in January 2007. The New Zealand Educational Institute, the teachers' union representing some early childhood teachers, fully supported the 20 Hours Free programme and published positive articles with titles such as '20 Hours Free ECE is a Great Advance, say Centres' (NZEI, 2007). Kindergarten Associations were undecided. New Zealand Kindergartens Incorporated, which represents two thirds of kindergartens (approximately 400) raised concerns about whether the Ministry of Education would consider the full range of costs kindergartens incur. Early Childhood Leadership (formerly the Federation of Free Kindergartens), which represents the other third, mainly in the Auckland area, criticised the ministry's reliance on operating costs to set the rates because it did not include the potential growth costs (Hotere, 2005).

Organisations opposed to Free ECE included higher-cost providers such as the Montessori Association of New Zealand (approximately 80 services) who did not plan to participate because they thought the funding rates were too low. But the most vociferous and media savvy opposition came from the Early Childhood Council. The ECC had been a vocal critic of the exemption of private providers from Free ECE and was now leading the opposition against participation in Free ECE. The organisation sent out a barrage of media releases announcing 'Thousands Face Missing out on Free Pre-school' and 'Early Childhood Education Plan Causing Problems' (Oliver, 2007; New Zealand Parents' Association, 2007). In February 2007 the council released the results of an email member survey in which only 23% of its services planned to participate in the Free ECE programme and 31% planned not to participate, and the undecided were leaning towards not participating. The survey was sent to 615 members and had a 43% response rate (Early Childhood Council, 2007a). Countering the ECC's message, the New Zealand Childcare Association released a member survey in early February 2007 indicating that 'over 90 percent of early childhood centres surveyed will either offer the government's 20 Hours Free service or are still considering the issue' (New Zealand Childhood Association, 2007). The survey was sent to its 470 members, with a 35% response rate (n=162). The two organisations sent out competing brochures. The ECC's brochure warned parents that centres would not participate in the programme because the government rate would not cover costs of centres with above average costs. The main message was that participation in Free ECE would force centres to lower quality because the government rate was too low and centres were not allowed to charge additional fees. The New Zealand Childcare Association countered by releasing an official statement, 'Free ECE – Get the Facts Right'. The release stated: 'ECC is promulgating a number of myths. We want to set the record straight for our members' (Bell, 2007).

As the 24 June 2007 deadline approached for services to declare participation in the programme, the tide started to turn. The Auckland Kindergarten Association, which had been undecided about participating, announced its decision to do so in June 2007 (Radio New Zealand, 2007). The indecision centred around the association's decision to allow optional fees. Although kindergartens were allowed to charge fees long before the Free ECE programme was developed, the Auckland Kindergarten Association had not instituted them. In its media release, the association indicated that it was instituting a 50 cent per hour optional fee but would consider withdrawing if its financial position was threatened (ibid.). It was with baited breath that all involved waited to see whether the implementation would be a success or failure.

The minister of education announced the initial implementation to be a success: '1703 services will be offering 20 Hours Free ECE from day one, which is a great start. More centres are still coming on board so the take up rate of 62 per cent of providers will increase further' (Maharey, 2007a). The minister referred to the new programme as a 'watershed policy', stating: '20 Hours Free early childhood education is the most significant expansion of the education system since the rollout of free secondary education by the first Labour government in the 1930s. For the first time in history, the state is recognising the need to provide free quality education for under five year olds' (Maharey, 2007b). He took pains to emphasise that the 20 Hours Free programme symbolised recognition that taxpayers see education of three and four year olds as essential; however, opponents continued to answer that 20 hours was a subsidy and not free. The ECC put out three media releases on 2 July 2007 taking issue with characterising the programme as free, as well as including ECC survey data on take-up rates (Early Childhood Education, 2007b). But the media coverage dwindled after the implementation of the programme. The initial take-up rate of 62% of services was high enough for the ministry and the prime minister to claim success. Evidence of the turnaround in media attention was a *New Zealand Herald* column by political analyst Colin James crediting Trevor Mallard with Labour's 'most important initiative, its biggest idea'. James likened the 20 Hours Free programme to investing in infrastructure, just like building roads, that would provide the path through which individuals' capacity to acquire skills and lift their earning power would ultimately contribute to their socioeconomic mobility. He then directed the government to do more for children from birth to age three (James, 2008). Clearly, 20 Hours Free, despite all the controversy leading up to its implementation, had secured its place in New Zealand early childhood policy.

**Policy options for the National-led government**

With the 2008 election, the National Party could have decided to reign in what had become an expensive early education programme. But the party's manifesto promised to expand eligibility to Playcentres and whānau-led Te Kōhanga Reo and to allow five year olds to participate. This effectively resolves the wedge issue created when these services were excluded from participation. However, expanded participation necessarily requires larger budget outlays. Free ECE is a demand-driven programme and the government has no control over the supply because it does not own the ECE services.[3] Each individual service decides whether to participate in the programme or not. Once a service decides to participate, then it can enrol as many children as legally allowed in the facility. Without control over demand or supply, Free ECE fast approaches becoming an entitlement programme. The challenge with any entitlement programme is that the government cannot easily control the budget allocation. The current expectation is that the government will fully fund the cost of ECE at the regulated quality level. With the National-led government's manifesto commitment, that means that the funding will be for an even larger group of services and children. The cost of the Free ECE programme, combined with the increases due to the quality improvements included in the ECE strategic plan (referred to as 'Pathways to the Future: Ngā Huarahi Aratake'), will continue to have an impact on the budget for years to come. The question is whether future governments will continue to absorb the increases or try to contain them.

The major choice before the National-led government is whether it will continue the paradigmatic shift toward universal provision or whether it will revert back to a subsidy programme. As Trevor Mallard envisioned, the 20 Hours Free ECE programme is supposed to be free because it is a statement that the government is committed to paying for quality early childhood education for all three and four year olds regardless of a family's ability to pay.

The National-led government has three policy scenarios related to consider.

1. *Stay the course:*
   The government could continue with a commitment to fund Free ECE at the regulated quality level and provide budget allotments to meet the demand. If the government chooses this option, it would achieve the quality and universal access objectives of the programme as envisioned, but it creates fiscal risk for the government. However, that risk could be mitigated by two factors. First, the reimbursement rate for Playcentres and parent/whānau-led Te Kōhanga Reo could be set substantially lower than for full-day, teacher-led services. That is because reimbursement rates are set based on the cost drivers of

providing ECE. Because these services have lower labour costs (due to reliance on volunteers) and because of the sessional structure of the programmes (in Playcentres and some Kōhanga Reo), the budget increases may be less than for other services participating in the Free ECE programme. Second, the programme already enrols 93% of eligible children, which means that the number of new participants may be quite small. However, there are data challenges in getting accurate enrolment estimates because children who utilise more than one service to fulfil the 20 hours of free ECE are counted twice in the current data collection method. An important factor in assessing the fiscal risk to the government is to estimate the maximum participation level. If enrolments are nearly at that level, then the fiscal risk would necessarily be reduced.

2. *Reduce fiscal risk by limiting the funding rate:*
The government could reduce fiscal risk by limiting funding increases for the 20 Hours Free programme. This scenario manages fiscal risk to the government, but there are two issues to consider. First, if funding rates do not keep pace with the cost of providing ECE, then quality would be sacrificed if services are not allowed to charge top-up fees. Through the ECE strategic plan, the government invested in regulatory and funding changes that improve the quality of ECE. If 20 Hours Free funding rates do not keep pace with the cost of quality, then the government will be reversing the gains made. Second, services may opt out of the programme. If a service finds that the funding rate does not cover the cost of its desired level of quality, then it could choose not to participate. This could effectively create a two-tiered system of higher-quality ECE for those who can afford to pay for it and lower-quality ECE for those who cannot. It would maintain universal access because any child could participate (assuming there are services with space available), but it would be universal access to lower-quality ECE.

3. *Reduce fiscal risk by reverting to subsidy:*
The government could reduce fiscal risk by limiting cost increases but allow services to charge 'top-up' fees. This scenario would change the 20 Hours Free programme from a universal programme to a subsidy programme. The fiscal risk to government would be reduced and the potential to maintain quality would be preserved. But the top-up fees may decrease accessibility for families who cannot afford the fees. Prior to the 20 Hours Free programme, this is how ECE services operated. The government provided a subsidy directly to the service to reduce the cost of provision for everyone, regardless of family income. It provided another subsidy specifically for families with greater financial need. By choosing policy option three, the government would reverse the paradigmatic shift that began with the creation of the 20 Hours Free programme.

Of the three policy options, scenario two is the least preferred because it creates the potential to decrease the quality of ECE provided by services. The government, through the ECE strategic plan, has made great strides in improving the quality of ECE and the newly-elected government would be wise to continue to fund those improvements. If services stop participating in the 20 Hours Free programme, it would also decrease the supply of ECE available to families unless they were able to pay the market rate.

Scenarios one and three represent a choice about the public realm: should ECE be publicly funded similar to primary and secondary education? Some sector advocates fiercely believe that ECE should be provided by government for all children. Former ministers of education Trevor Mallard and Steve Maharey both viewed the 20 Hours Free programme as a watershed moment in New Zealand policy because for the first time the government made a commitment to fully funding (at the regulated quality level) early childhood education for all. If the National-led government continues on this pathway, New Zealand will achieve this paradigmatic shift in government responsibility for three and four year olds. However, that policy choice has to be made with a wider lens beyond ECE. Every government always has more worthy programmes than it can afford to fund. The question for the government is the opportunity cost of the 20 Hours Free programme funding increases. Are there other public investments that are more pressing? For New Zealand the question is whether the education and care of three-to-five year olds is more important than, say, paid parental leave, expanded social welfare funding or infrastructure investments. Philosophically, the provision of ECE should be considered just as important as primary and secondary education. However, the relative importance of Free ECE can only be determined within the broader context of government priorities.

The newly-appointed minister of education, Anne Tolley, announced in November 2008 that new ECE regulations to have been implemented on 1 December would be delayed for six months to enable the ministry to consult with the sector and parents (Tolley, 2008). While those regulations were already passed into law by the previous government and will go into effect unless new legislation is passed to stop them, her action could be a signal that the National-led government wants to reassess the investment in ECE. The new government also dropped 'free' from the programme title, which could signal that the government will move in the direction of scenario three. The investment in ECE over the last several years due to both the 20 Hours Free programme and the ECE strategic plan represents a quantum leap in government support of early childhood education. The government needs to carefully consider its options and their potential impacts before reversing the course of action currently in place.

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1 Note that the spending data for ECE are from July 2007 to September 2008 and the budget data are for the fiscal year.

2 In addition to Ministry of Education ECE programmes, the Ministry for Social Development spent $150 million on childcare assistance in 2007-08, with a $17 million increase for the 2008-09 fiscal year (New Zealand Treasury, 'Vote Social Development', M63, p.285).

3 The government does not own ECE services except for the Correspondence School, and that service serves fewer than 1% of enroled children (see Table 2).

**Table 2: Children on the regular ECE roll as at 1 July 2007 by type of service, form of ownership and age**

| Service Type | | No. with regular roll | Age at 1 July 2007 | | | | | | TOTAL | % of roll |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | Under 1 | 1 Year | 2 Years | 3 Years | 4 Years | 5 Years | | |
| Free Kindergarten | Community-based | 618 | 25 | 37 | 1221 | 16079 | 25973 | 360 | 43695 | 26% |
| Playcentre | Community-based | 465 | 1731 | 2891 | 3896 | 3590 | 2465 | 91 | 14664 | 9% |
| Education and Care Service | Community-based | 794 | 1422 | 5113 | 9006 | 11881 | 10307 | 443 | 38172 | 22% |
| | Privately-owned | 1133 | 2800 | 9247 | 13841 | 15387 | 11986 | 300 | 53561 | 31% |
| Home-based network | Community-based | 83 | 284 | 915 | 994 | 889 | 616 | 39 | 3737 | 2% |
| | Privately-owned | 137 | 934 | 1828 | 1843 | 1452 | 1137 | 142 | 7336 | 4% |
| Te Kōhanga Reo | Community-based | 470 | 607 | 1751 | 2235 | 2351 | 2181 | 111 | 9236 | 5% |
| Correspondence School | Other | 1 | | 1 | 4 | 289 | 392 | 51 | 737 | 0% |
| **TOTAL** | | **3701** | **7803** | **21783** | **33040** | **51918** | **55057** | **1537** | **171138** | **100%** |

Note: In 2007 data was not available for nine services (five Education and Care, three Home-based networks and one Playcentre). In addition, four licensed services were newly opened at the time of the census and therefore had no enrolments. These services are excluded from the number of services with a regular roll. Excludes casual education and care.
Source: Data Management Unit, Ministry of Education

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