CHAPTER FOUR

Economic Management

INTRODUCTION

The importance of rights and the institutional arrangements that determine them was discussed in Chapter 1. That discussion established that the issue facing the Government was not a choice as to intervene or not but rather it was a question about how to intervene.

This part of the brief focuses on the range of instruments for intervention that the Government has at its disposal. These include monetary policy, taxation, expenditure and regulation. All of these interventions can greatly influence the way people behave. They can act to constrain or expand the opportunities open to people and organisations. They can significantly alter the incentives that affect economic performance.

A comparative institutional approach is advocated by which each intervention is assessed in terms of its impact on efficiency and equity relative to the same benchmark. The benchmark used is usually either the status quo or the outcome under voluntary contracting. Such analysis needs to take account of the world we live in. In particular the existence of uncertainty, limited information and the possibility of opportunistic behaviour can substantially influence the choice between interventions and help establish whether one set of institutional arrangements is likely to be preferable to another.

Both macroeconomic interventions and microeconomic interventions should equally face these tests. In each case the potential benefits of such intervention must be compared with the costs. This comparison should take account of all the effects of the way that the policies will actually work in practice. Poorly designed macroeconomic policies can add to inflation and create policy uncertainty. At rhe microeconomic level government expenditures and regulations can distort economic incentives and lower overall productivity. Large amounts of intended assistance may never reach their targets due to unexpected interactions. Moreover the costs of financing any expenditure may also be high or divert resources from more productive uses. The effect of diverting resources away from higher valued uses in the economy is that overall growth and employment can be adversely. affected. By providing a signal that it is prepared to use its powers to redistribute income in favour of certain groups, the Government may encourage people co divert effort into lobbying for assistance. Underlying this analysis is the concept of scarcity and the need to use resources in ways that contribute to better overall outcomes.

Equity should be an important concern in the formulation of both macroeconomic and microeconomic policies. Economic management should nor be an end in itself but the means of supporting a better life for New Zealanders. To this end a distinction between economic policy and social policy does not seem helpful. For example, improved economic performance that leads to lower inflation and higher growth can be just as important for improving equity as it is for increasing efficiency. Equally the efficient provision and regulation of social services is important.

To the extent that economic policies increase the incentives to generate more wealth to operate more productively this will provide a basis for returning the economy to sustainable job creating growth. The more flexibly people are able to contract with each other in as unconstrained manner as possible the more equitable the outcomes are likely to be.

In assessing the case for an intervention it is important to consider the longer term effects as well as the short-term impacts. In particular an intervention can influence a much wider range of activity and behaviour than often recognised. These effects reflect, in part the dynamic nature of the economy. Some interventions such as a tightening of monetary policy may have adverse short rerm impacts on employment and growth. On the other hand lower inflation provides benefits by encouraging higher overall living standards in the future.

Running through the Economic Management part of the brief are a number of themes that should contribute to effective policy.

Consistency

Uncertainty and risk are an everyday aspect of economic life. One part of that uncertainty is policy uncertainty. The less certain it is that a policy will be sustained, the more effort that is likely to be diverted into watching the Government, second guessing the Government and lobbying. Policies will transparently signal the Government's policy intentions if a consistent line is adopted. This will promote confidence and assist people and organisations in making longer term investment decisions.

Credibility

The expectations held by people are important. People adjust their behaviour in the light of what they expect to happen. For example wage bargains will reflect expectations about inflation and the ability to pass on costs. This is why disinflation is a costly process. People do not readily accept that the Government will stick with its intentions to adhere to strict monetary and fiscal policy. If there is a belief that policy will be reversed or that Government will nor exercise its powers to penalise them adjustment will be slow. The more credible the policies the more rapidly adjustment will occur.

Information .and Uncertainty

Information and its quality is important. The more transparent the policy the more easy it is to monitor. The more blurred the information then the greater are the risks faced by decision makers of taking the wrong decision.

In evaluating interventions it is also important to consider the information disabilities faced by decision makers and the incentives faced by individuals and groups to fully inform themselves on, or to research out the implications of a particular intervention. For example those advocating assistance to or regulation of particular activities have little incentives to research our the wider implications of their proposals. Similarly practices that at first hand may appear uncompetitive such as retail price maintenance, may in fact be efficient ways of dealing with uncertainty, risk and opportunism.

Neutrality

Economic policy should be concerned to promote better economic performance across the entire economy. Assistance to one industry or sector simply represents a tax burden on other sectors. For example current levels of tariffs and assistance structures still mean that a bias against exports exists in the current policy mix. The more even handed the approach the better overall economic performance is likely to be.

Competition

Assistance and regulations that restrict new entrants act to reduce incentives to innovate and increase efficiency. For this reason we remain concerned about some of the provisions in the 1987 Labour Relations Act and see a need for ongoing regulatory review.

Institutional Arrangements

The processes by which policy is formed, both in terms of advice and implementation is important. The stubborness of inflation, the difficulty of controlling and evaluating expenditure, and a high degree of regulation can all reflect biases built into current institutional arrangements. Thus the range of possible reforms discussed in Chapter 1 of the brief would contribute to improved policy design of government interventions. These would act to increase accountability, transparency and information flows.

Policy Priorities

This chapter of the briefing identifies a number of policy priorities. In many ways these priorities should be seen as mutually reinforcing each other in the contribution they can make towards sustainable growth and low inflation.

Quite clearly the economy is going through a major adjustment. This adjustment is being stimulated by strong pressures being introduced in a number of parts of the economy to improve performance. Benefits of this are showing through in the form of more sophisticated management practices, the emphasis on increasing efficiency and the diversification into new products and markets.

The costs of the adjustment are being reflected in the costs of high unemployment, much of which has impacted upon regional areas. It needs however to be recognised that a number of these costs are short term ones that reflect the costs of securing low inflation and a more neutral economic environment.

Inflation

The more rapidly inflation can be reduced the sooner growth will return. Inflation has proved stubborn. While monetary and fiscal conditions have not always been kept appropriately firm, we believe however that monetary control has now been reasserted and the preconditions exist for a significant decline in inflation over the next two years. To achieve this though it will be important that monetary conditions are kept tight and that monetary policy is supported by other policies.

Public Expenditure

Current levels of public expenditure represent a significant tax burden on the economy. The costs of financing this expenditure is acting to discourage effort and saving. At the same time there are a number of reasons for believing that the quality of this expenditure could be significantly improved. It is therefore important that expenditure programmes be comprehensively examined in terms of their cost effectiveness.

In both the monetary and fiscal area there does appear scope for some changes to institutional arrangements in order to increase the accountability of decision makers in those areas.

Debt

High debt levels represent a burden on the economy. They also imply a risk of a break in confidence. For this reason we think it prudent for the Government to act to reduce those debt burdens in relation to Gross Domestic Product (GDP) over the next three years.

Industry Assistance

Current levels of industry assistance are imposing a bias against exporters. Upward pressure is being placed on the exchange rate and the disinflation process is not being assisted as much as it might. We see the forthcoming review of the post 1787 tariff arrangements as being critical. In particular we consider that tariffs should continue to be reduced towards lower levels at an accelerated rate. Import licensing should be removed from the few areas where it still remains.

Regulatory Reform

Regulations or restrictions raise complex issues and can only be examined on a case by case basis. Reviews undertaken to date have indicated significant scope for reform. A substantial number of other regulations warrant review. More generally concern exists about biases in current institutional arrangements that encourage over-use of regulations. A priority remains therefore for *both* an ongoing process of review and a need to examine the processes by which regulations are promoted and implemented.

Labour Market.

Labour market performance clearly remains a major concern. Progress in all the above areas would all contribute to improved labour market performance. More specifically though we still see many aspects of labour market regulation and some aspects of employment and training policy as unsatisfactory. In particular we retain major concerns about a number of aspects of the 1987 Labour Relations Act. We also believe that wage regulations in a number of areas affecting rhe labour market are acting to restrict employment opportunities while at the same time contributing little to meeting overall equity goals.

Taxation

Despite the substantial improvements which have been made to the tax system over the past three years, much remains to be done to reduce its efficiency costs and to improve equity outcomes. The desirable direction for tax policy is clear. The income tax base needs to be broadened further by eliminating unjustified concessions and by addressing differences in the Income Tax Act. The rate of GST should be increased in due course without eroding its base and while maintaining a uniform rate of tax. This would take some pressure off the income tax system, reduce disincentives to invest and save and lessen the distorting impact on the tax system of inflation. The additional revenue from these interrelated moves should, consistent with the Government's overall fiscal objectives, be used to lower and reduce disparities in effective personal marginal rates of tax, and to lower company tax and those selective indirect taxes which do not stand up well against the standard criteria. In addition, consideration needs to be given to improving the operation of the tax system by attempting to improve voluntary compliance which is reported to be at a low ebb.

Conclusion

We consider that a basis now exists for sustained improvements in New Zealand's overall economic performance. To secure this, though, it seems vital that the disinflation process is maintained; that it be supported by further fiscal consolidation, a further evening out of assistance structures across the economy and an ongoing process of regulatory reform.

For the Government's part we emphasise the need and importance of maintaining a transparent and open approach to policy making. Such an approach will impose considerable discipline on government processes but will contribute to favourable economic outcomes by being seen as enhancing the consistency, credibility and mutually reinforcing aspects of policy.

CREDIBILITY, PACE AND SEQUENCING OF REFORMS

Introduction

Wide ranging economic reforms raise questions about the speed of reform and the order in which reforms should be undertaken. Linked to this is the issue of the credibility of government action. This section addresses in general terms a number of the issues involved. As such it provides a basis for considering the more specific issues raised in the following sections on disinflation, industry assistance, the labour marker and regulatory reform.

There are a number of institutional considerations which affect the design and implementation of policy. The most obvious are the limits on Ministers', Parliament's and officials' time. Another significant constraint is the Government's ability to collect and correctly analyse information. This suggests that gains in resource efficiency are possible where reform programmes can adopt a common approach to a number of different policies. For example, the application of a common set of principles when assessing the operations of state-owned trading enterprises. This consideration is particularly important when wide ranging reforms are being contemplated. The constraints which governments face in collecting and correctly analysing information imply that policies will be more effective when they are permissive rather than prescriptive about outcomes. In general, this implies that decision making should rest with those who stand co gain or lose the most from a specific action.

Credibility

People organise their affairs based on their expectations of the future. The behaviour of the Government in the past and the present, and its stated intentions for the future are important in shaping these expectations. Because the Government's influence is indirect, the credibility of its actions has a major bearing on the speed with which people react and the extent of that reaction. For example, lower inflationary expectations, through their effects on wage and price formulation, may be critical to reducing inflation without significant output losses.

If there is doubt about the Government's intentions, the reaction may be slow, or in extreme cases non-existent. The experience of adjustment in the rural sector illustrates this point. At present, there is a widespread public belief that the Rural Bank will not take enforcement action against farmers in arrears unless they have already vacated their properties. This perception is said to be one of the principal reasons for the lack of progress in debt restructuring. This in turn has prolonged the adjustment and its associated stresses, and retarded recovery, for example by discouraging lenders from extending seasonal credit for fertiliser or other farm inputs.

Credibility can be enhanced in the following ways:

— making the direction of policy clear, and unequivocal;
— adopting consistent and mutually reinforcing policies;
— avoiding policy reversals, and increasing the incentives to avoid them, for example by ensuring that a reversal is obvious to all if it occurs. In effect this creates a bond between the Government and the, community regarding the durability of its policies;
— clearly explaining the benefits of change. This can reduce the pressure exerted by interest groups to reverse a reform.

Pace

If resources were able to move costlessly from one activity to another, it would be a simple matter to determine the optimal pace of reform. The desire to enjoy the maximum benefits of reform would mean that immediate change would always maximise community welfare. However, in reality resources do not move costlessly between uses. From an economic viewpoint, pace should be determined by balancing the desire to obtain early benefits from the reform, against the costs involved in the transition. This is analogous to considering an investment project, where costs are initially incurred, so as to reap future benefits. By altering the period over which the change takes effect, the net benefits can be increased.

While there are many reforms about which one can be confident that the benefits substantially exceed the costs, it is usually very difficult to precisely determine the pace which maximises the difference between the two streams. The shape of the benefits profile is particularly hard to estimate, as the benefits tend to be of a dynamic nature, and their effects are therefore quite subtle. Nevertheless, the analogy does provide a useful framework with which to proceed.

In general the pace of reform will affect the timing of benefits, but not their level. Faster reform will enable earlier enjoyment of the full benefits. The only notable exceptions to this occur when adjustment is constrained, for example due to physical or biological factors, and even in these cases it is likely that the potential will exist to take some advantage of the new opportunities.

In contrast, the total costs are likely to vary to a greater extent. The costs of transition derive from two principal sources:

- assets cannot always switch easily from producing one output to another. Often, the assets need to be modified in some way, which has a direct cost, for example the costs of retraining a worker, or establishing a new team; and
- the output that is foregone during the period that resources are between uses.

Assets in this context should be interpreted in a wide sense to include both physical and human capital, and social arrangements.

The costs involved in transforming all of these assets are relevant, although their size and profile may differ somewhat. For example, human capital consists of two major components, those skills that are specific to a particular workplace, and those that are general to a number of organisations. Policy changes which displace people with relatively large investments in workplace specific capital will have different adjustment costs from reforms which principally impact on workers with more general capital.

A key determinant of adjustment costs is the degree to which assets are specific to particular uses. The less specific the assets, the more easily they will be absorbed or transformed for use in other areas, and the lower will be the cost of transition.

This point is borne out by the experience of reform over the last three years. For example, the reduction of assistance to import substitution activities has proceeded at a moderate pace, without any signs of major adjustment difficulties. By comparison, reform of assistance in the financial sector has occurred at a much faster pace, again without major difficulties. This can be attributed mainly to the greater ability of resources within the financial sector to adapt to new uses, and the high degree of commonality between the old and new demands. These factors have also allowed a great deal of the adjustment to occur within firms, rather than between them.

Where asset specificity is high, lengthening the period of change may allow assets to be transformed at a lower cost. For example, it could allow a greater proportion of adjustment to occur within firms, rather than between them. More importantly, gradual change could reduce search costs and allow people to more easily obtain information about alternative resource deployments, and thus shorten the period during which resources are idle. These considerations are likely to be particularly relevant in situations where human capital is very specific, because of say specialised skills or knowledge or workers' locational preferences.

However, lengthening the period of change can be costly. It increases the risk that new resources will be attracted into poorly performing activities and, at the very least, would divert variable inputs into areas where they contribute less than they could elsewhere. There may also be some circumstances where prolonging change actually increases adjustment costs. For example, there is some evidence to suggest that while policies to achieve rapid disinflation will have higher initial adjustment costs, total costs could be lowered because the initial cost can shock people into a faster change to their wage and price setting behaviour, thereby promoting a faster and less costly transition to low inflation.

Pace of reform and policy credibility may be related. For example, a policy intended to elicit very rapid adjustment might be thought so unlikely to survive that it actually discouraged change. On the other hand, a very gradual reform might be regarded as such a concession to vested interests that it too would lack credibility. A balance must therefore be struck between a policy that is so aggressive that reversal is thought highly probable, and a policy that is judged so feeble that it lacks credibility.

A key consideration in weighing this issue is the degree to which the Government's credibility has already been established in related areas. If a good reserve of credibility has been accumulated, this increases the scope for the Government to undertake decisive and rapid reform.

Reform of other policies can influence the costs of adjustment. For example reform to wage fixing and labour market regulation may make it easier for employers and employees to adjust to the new environment. This could permit say greater regional wage variation to reflect differing employment opportunities and costs of living.

The discussion above suggests that, in principle;

- i the optimal pace of reform involves a trade-off between:
  - a the desire to get price signals correctly aligned as soon as possible to redeploy resources and hasten the enjoyment of benefits;
  - b the wish to reduce adjustment costs, which depend principally on the degree of asset specificity in the relevant activities. The greater the specificity, the higher would be the adjustment costs for any given period; and
  - c the need to retain policy credibility; and
- ii other policy reforms can reduce adjustment costs and support a more rapid pace of reform.

While it is desirable that reform programmes take account of varying degrees of asset specificity, it must also be emphasised that information constraints substantially limit the degree to which it is possible to tailor programmes to specific conditions. Furthermore, attempts to do so can create incentives amongst those affected to exaggerate the likely costs of adjustment. As a general observation, the experience of reform to date suggests that adjustment costs typically tend to be overestimated beforehand. A large number of changes have occurred which have elicited fairly smooth and rapid adjustment. For example the response to trade liberalisation under closer economic relations with Australia (ANZCERTA) has been very positive, in contrast to the predictions of many commentators at the time of its introduction. The conclusion also holds at the macroeconomic level. Significant gains have been made in reducing inflation and fiscal imbalances without major output or employment losses.

More general approaches can enhance credibility of policy direction by avoiding the appearance of the Government making concessions to interest groups. This is particularly important where the principles which underpin reform are not widely understood by the community. An example in the industry policy area is given by industry plans, where some commentators perceive that a concession has been granted, despite the fact that some activities covered by plans are undergoing reform which is more rapid than that within non-plan areas.

Sequencing

Policy programmes often consist of a large number of specific elements. If reforms could be implemented instantaneously and adjustment to policy were rapid, the sequencing of the elements would not be a major issue-simultaneous action would be the desired course. However, because there are lags in implementation and adjustment can take some time, the order and timing of the introduction of policy elements can have an important bearing on outcomes.

The general concern in sequencing is to avoid circumstances where a pattern of resource use is encouraged which is inconsistent with medium term considerations, and is subsequently costly to modify. To illustrate, a policy approach which encouraged investment in import substitution manufacturing and then later discouraged it should be regarded rather warily.

In some situations it may be necessary to implement specific elements in an incremental manner to allow time to make the necessary policy changes, or for people to adjust to the new environment before subsequent changes can be introduced. For example, it was necessary to lift interest and exchange rate controls before the currency could be floated.

While the objectives of optimal sequencing are clear, it is frequently very difficult to devise policies in relation to a specific area of reform which meet these objectives precisely. This can be attributed to the inconclusive nature of theoretical debates on many sequencing issues and the difficulties in obtaining sound information on the effects of reform. An example illustrates this point. The liberalisation of product and capital markets is an area where there has been considerable discussion of sequencing issues. Some commentators have argued that capital markets should not be liberalised before product markets, because investment patterns would be based on a distorted environment. They felt that when product markets were later liberalised, some of the investments would prove to be poor, but could only be reversed at a cost to society. The view that investment will be misallocated assumes that investors will not take into account the Government's future intentions regarding product market liberalisation when making their decisions. Thus, the argument ultimately rests on the assumption that firms and individuals have limited foresight and that governments and their advisors by comparison have significant advantages in acquiring and analysing information.

Others have argued the case that capital market liberalisation should proceed first. This is based on a view that product market liberalisation requires considerable resource reallocations. This adjustment will be more difficult and costly if access to the capital market is highly restricted.

The bounds of knowledge in this area highlight the dangers of adopting a spuriously technical approach to sequencing issues. A set of broad principles provides a more useful way ahead. The principal considerations are:

- i policies which provide signals to private decision makers that are consistent with the desired'medium term objectives are generally desirable. For example, assistance to activities within the tradeables sector should be reduced at broadly the same rate so as to avoid intra-sectoral resource movements which would later need to be reversed;
- ii in circumstances where some short term incompatibility of price signals is inevitable, ensuring that private agents possess appropriate information about the longer term policy environment will reduce undesirable resource movements. As long as government intentions are clear and credible, short run effects will be less significant;
- iii political economy considerations can be important. For example, opportunities for reform can arise on a piecemeal basis and are sometimes of a limited duration. The risks of difficult adjustment need to be assessed in relation to the cost of missed opportunities;
- iv more rapid reform can reduce the periods during which price signals diverge from their desired level. Because resources take time to move, shortening the duration of periods when price signals are 'incorrect' will limit undesirable resource movements;

v the nature of the policy making environment can be important. Governments often come under pressure to implement policies in a manner which protects or enhances particular interests. Sometimes these interests are aligned with the common perception of the community good, and in other cases they are not. Policies which take into account the likelihood of such pressures developing will generally have a higher probability of achieving successful outcomes; and

vi keeping policies under review allows remedial action to be taken if difficulties do emerge. This can range from better signalling of future intentions, to modification of the relevant policy, or the introduction of new supporting measures.

The experience of recent reform in New Zealand has not raised any particular sequencing problems which could have been easily avoided. Undertaking a simultaneous programme of stabilisation and liberalisation has, as expected, involved some tensions. However, it is difficult to know whether an alternative policy mix would have been better. Many of the effects of the policies are mutually supportive and reinforcing. Indeed, as discussed elsewhere in this chapter the consistent under-forecasting of the strength of economic activity suggests that substantial benefits of liberalisation are materialising in spite of the short term interest and exchange rate pressures on the tradeables sector. If anything, the experience of reform to date suggests that the main dangers lie in moving too slowly.

Distributional Effects

Economic reform and the manner in which it is implemented can have significant distributional effects, especially in the short term. For example the pace of change can alter the distributional impact of reform. In some cases slower reform will spread the distributional impact more thinly over a longer period of time, and those adversely affected may suffer smaller income losses. Conversely, the potential beneficiaries will not receive the full gains because of postponement. Where changes in incomes streams are rapidly capitalised into asset values, as in the case of New Zealand Steel shares or rural land, the distributional impacts will be apparent fairly quickly.

These distributional effects often generate pressures on the Government to compensate those who feel they have been adversely affected by reform. The question as to whether compensation is desirable raises very complex issues.

Residual risk-takers, that is those people who stand to gain or lose the most from certain actions, must form expectations about a wide range of factors, including the future policy environment. It is not obvious why the losses from this source of risk should be socialised while the gains are privatised. There would probably be little support for taxing those who realised substantial wealth gains because of the rise in rural land prices in the late 1970s and early 1980s.

However, in some situations unanticipated changes in government policy could reduce confidence in the durability of future policy. In extreme circumstances this could reduce the opportunity for beneficial reform. It could be argued that compensation would counter this risk by ensuring that 'policy surprises' were not costly to individuals. However, compensation would have a number of serious adverse effects which are discussed below. A much better way of reducing undesirable 'surprises' is to maintain a clear and consistent policy direction, and to signal changes in advance of their introduction where appropriate.

If it became widely known that certain groups were receiving compensation, as is likely, it would tend to encourage other groups to act strategically to resist change in order to promote their claims. This would raise the cost of change for society and reduce the scope for beneficial government action.

Compensation would tend to discourage people from taking their own action to reduce their exposure to losses, such as diversifying their assets, which would often be the most efficient approach from a national perspective. The efficiency costs of raising additional taxation revenue to fund compensation proposals is an additional concern.

There would also be a host of practical obstacles to overcome. It would often be exceedingly difficult to identify with precision those adversely affected by policy change. This would be especially so when a major programme of reform is taking place. For example, it would be impossible to accurately establish the distributional effects of floating the exchange rate. Furthermore, the first round effects of reform are not necessarily the most important or relevant, even though they are the effects upon which attention tends to be focussed. Many of the benefits of reform are dynamic and only accrue after a period of time. A short term focus on 'winners' and 'losers' could be very misleading.

The final point is that the degree of hardship suffered by individuals is not necessarily related to the magnitude of their losses. A wealthy person is better placed to withstand a loss of $500 than a poor one. It could therefore be argued that on equity grounds there is a good case for relating any compensation to the degree of hardship engendered by a loss. Such an approach would be consistent with general social welfare policies which emphasise need, rather than cause of distress.

These considerations suggest that there is little justification for specific interventions beyond access to the general programmes for social support.

THE EXPERIENCE WITH DISINFLATION

Introduction

By 1984 the combination of highly expansionary fiscal and monetary. policies and a comprehensive freeze on wages, prices and interest rates had created a highly. distorted economy in which there was a great deal of suppressed inflation. As the controls were relaxed and other liberalisation measures were put in place, 'the underlying inflation asserted itself, with the annual increase in the CPI rising from 3.5 percent in the year to March 1784 to 16.6 percent in the year to June 1785.

Starting with the 1784 Budget, macroeconomic policies have been aimed at restraining the growth of nominal demand in the economy in order to reduce inflation to rates similar to those prevailing in New Zealand's main trading partners and, eventually, to deliver price stability over the medium term. These policies have unavoidably entailed some costs in the form of output losses and unemployment as the economy has adjusted only gradually to a monetary environment designed to accommodate only low inflation.

This section reviews and assesses the experience with disinflation. The first part discusses some considerations which must be taken into account in formulating a disinflation strategy. The second part reviews macroeconomic developments since 1984 and assesses the prospects for further progress on disinflation. The final part offers concluding remarks.

Considerations in Formulating Disinflation Policy

The Rationale for Disinflation

A number of difficulties arise in coping with high inflation:

- high inflation is almost always variable. This prevents expectations from being formed accurately or being held with much certainty, making it difficult to arrive at mutually advantageous contractual agreements. Those that are formed often have arbitrary and inequitable distributional effects as expectations are not realised. This is particularly important in financial and labour markets;
- it is difficult to distinguish price changes that are part of an inflation process from relative price changes. Efficiency costs result because the signals provided by relative price changes are blurred;
- high inflation interacts with a nominal income based tax system to distort economic decision making and resource allocation.

These considerations suggest that it is unrealistic to hope that the costs of inflation can be mitigated by learning to live with it. To create an environment in which the benefits of the reforms which have been taking place will be most quickly and fully realised, therefore, disinflation should continue until broad price stability is restored.

Minimising the Costs of Disinflation

Overseas experience suggests that successful disinflation almost invariably entails costs in the form of temporarily lower output and higher unemployment. The costs have two principle sources. First, during a disinflation process inflation is typically neither accurately anticipated nor correctly incorporated into the formation of wages and prices. This occurs for a variety of reasons: scepticism about the Government's commitment to disinflation; uncertainty about what this would actually imply for the near future even if the general commitment were believed; perceived needs to maintain relativities, profit margins, and so on; and the tendency to compensate for past inflation to maintain 'real values'. The result is that nominal wages and prices are systematically set too high in relation to the (falling) inflation rate which monetary policy will accommodate. This results in a general deflation of real aggregate demand. While it is doubtful that the costs from this source can be eliminated entirely, the Government can do a great deal to reduce them by making its commitment to eliminating inflation absolutely clear and credible.

Second, the costs of adjustment to change of any type (not just those caused by disinflation) depend on the speed with which resources can shift into new uses. Factors influencing this speed include the responsiveness of relative prices to supply-demand imbalances, the availability of information, the extent to which opportunities are closed off by restrictions on entry, the costs of searching for the best opportunities and impediments to mobility. Further liberalisation measures in both product and labour markets would lead to improvements in these areas and facilitate faster and less costly adjustments. Among the more helpful reforms in this area would be further reductions in border protection, which would enhance price flexibility by exposing product markets to more competition; further reforms of the national award system, which would allow greater flexibility of wage relativities to reflect conditions specific to individual regions and industry; and an ongoing programme of regulatory review and reform.

An unfortunate aspect of the disinflation process is that the burden of adjustment has been spread unevenly across the various regions and sectors of the community. To some extent this is inevitable since monetary restraint is reflected in financial markets in the first instance, with the result that those activities whose fortunes are most closely tied to interest rate and exchange rate developments come under the most direct and immediate pressure. As those engaged in these activities are forced to adjust, the pressure is transmitted to the wider community as weaker demand spreads to suppliers and lower incomes lead to reduced consumer spending. There is a great deal, however, that improved government policies could do to ameliorate the unevenness of the adjustment burden, principally by ensuring that these sectors and activities which are currently sheltered or protected are exposed more openly to market pressures. Most of the reforms suggested above would have this effect, and can therefore be seen as likely to spread the burden of adjustment more evenly as well as reducing the overall costs.

The Speed of Disinflation

In view of the unavoidable costs of disinflation, judgements about speed are required. A concern to allow expectations to adjust and to reduce the risk of an excessively deep downturn has resulted in a degree of caution in the implementation of disinflation policy. In retrospect, it is clear that despite prospects of further improvement, reductions in inflation to date have not been proceeding excessively rapidly. While a concern exists that if a severe recession resulted from rapid disinflation' political support for the entire restructuring programme would be undermined, the balance of considerations argues for accelerating the pace of disinflation.

First, practical difficulties may arise with a cautious, or gradualist, approach. It requires that the monetary authorities manage major economic variables in a desired way over a substantial period of time. The problems of doing this successfully have much in common with those of conventional efforts to smooth the cycle (for example lack of information, unpredictable lags). It is easy to bias the policy stance toward excessive ease, in which case no significant sustained disinflation takes place, because the caution is motivated by a desire to avoid erring in the side of being too tight.

Second, the political support argument does not unambiguously favour a cautious approach. The erosion of political support for disinflation policies may relate to duration, as well as to the depth, of the recession. To the extent that this proves to be the case, political pressures will build up persistently, with those suffering the costs most directly demanding evidence of the 'real benefits' of the strategy. This can force abandonment of a disinflation policy before it has time to succeed.

Finally, if, for whatever reason, a cautious disinflation policy is not successful the credibility of future governments, as well as the present one, will be damaged. Inflation expectations will be all the more deeply ingrained and future promises to reduce it will be met with even more scepticism than at present.

New Zealand's Experience with Disinflation

Since 1784 macroeconomic policies have been directed toward restraining the growth of nominal demand in order to put downward pressure on inflation. Fiscal policy has been restrictive, as the financial deficit came down from 6.7 percent of GDP in 1983/84 to 3.1 percent of GDP in 1985/86. While there was some slippage during 1986/87, the financial deficit in 1987/88 is expected to fall further to 2.2 percent of GDP. The degree of monetary restraint that has been imposed has been less steady than might have been desirable. This partly reflects an underestimation of the strength of economic activity and the related concern to avoid precipitating an excessively severe downturn during 1785 and 1786, and partly to difficulties of interpreting the financial and economic indicators and adjusting liquidity management settings soon enough. Nevertheless, despite some easing of conditions during 1786, which has resulted in an undesirable delay in disinflating, monetary policy has been restrictive enough to put the real economy under some pressure. This has led to a gradual reduction in inflation with further improvements in prospect for the next two years.

TABLE 4.1: Financial Indicators

Date	*Nominal* Interest Rates (percent per *annum*) Short[1]	Long[2]	Yield Gap[3]	Real Interest Rate[4] (percent per annum)	Exchange Rate[5] (Index. June 19 79 = 100)
January 1985	18.0	17.6	-0.4	5.0	63.7
October 198 5	25.0	19.5	-5.5	8.4	72.5
September 1986	15.6	15.8	0.2	5.2	60.2
March 1987	26.1	17.5	-8.6	12.3	65.1
11 August 1987	17.9	16.4	−1.5	7.3	66.8

[1] 90 day commercial bills (end of month, except 1 1 August 1737)

[2] 5 year government bonds (end of month, except 11 August 1987)

[3] (2) less (1)

[4] (1) less latest published six month increase in the CPI at an annual rate. March 1987 figure adjusted for GST effect as described in note to Table 4.3.

[5] Trade-weighted index

Source: Reserve Bank

Table 4.1 shows the behaviour of selected financial variables since the beginning of 1785.

— following the float of the exchange, rate money market rates rose steadily from their levels at the beginning of 1785 until October of that year. This resulted in a steeply inverted yield curve, with long term rates substantially below money market rates, which is usually an indication that the system is under pressure. In real terms, short rates moved from around 5 percent, to over 8 percent. During this period the nominal exchange rate appreciated by around 15 percent;

— conditions eased during much of 1986. By September money market rates had fallen below long term rates, real interest rares had fallen back to levels prevailing before the float, and the exchange rate had weakened substantially;

— after adjustments in liquidity management settings between late September and early November 1986, monetary conditions similar to those prevailing in 1985 were reasserted. The rise in interest rates which took place was accentuated by a growing concern in financial markets about the fiscal situation following an upward revision in the outlook for the deficit for 1986/87 when the Supplementary Estimates were announced in December;

— following announcements that the fiscal deficit for 1986/87 had turned out $1 billion lower than anticipated and that further improvements were expected in 1987/88, together with a favourable March quarter CPI, confidence in financial markets improved. An easing in money market rates since March/April together with continued strength of the exchange rate is consistent with a fall in inflation—expectations rather than an easing in monetary conditions;

— the present situation is one in which monetary conditions appear only moderately firm. Short term interest rates, although significantly lower than four or five months ago, remain more than 7 percent above the rate of inflation since the beginning of the year, and the exchange rate remains reasonably strong. Against this, the failure of long-term rates to fall in line with short-term rates indicates that expected inflation remains high. This is confirmed by survey and anecdotal evidence, while the resultant flattening of the yield curve suggests that the money markets do not feel themselves to be under pressure.

While real demand and output have slowed down substantially since 1984, the striking feature of the past three years is that the slowdown has never been as sharp as expected and has never for any length of time involved a sustained fall in activity. The outlook has consistently been for a decline in output during the next year with the anticipated gradual recovery being pushed forward by a year as new information has forced upward revisions in the assessment of the current situation. The most recent forecasts continue to display this pattern (Table 4.2). This contributed to the difficulty of fixing liquidity management settings sufficiently tightly, notably during mid-1986. The persistent underestimation of the strength of the economy appears to derive at least in past from the difficulty of incorporating the likely effect of liberalisation measures into assessments of the macroeconomic situation. In some areas the benefits of liberalisation have created favourable demand conditions (for example in financial services) despite the weak macroeconomic picture. In others, particularly where industries are exposed to international competition, rapid restructuring has enabled producers to maintain surprisingly high levels of output and activity despite the strengthening of the real exchange rate. Perhaps most important, deregulation of the financial sector has allowed households to maintain consumption levels by increasing their borrowing in a way that was not previously possible, and high inflation expectations have made them willing to do so despite high levels of retail interest rates.

TABLE 4.2: Real GDP Forecasts and Outturn

Estimates and Forecasts	*1984/85*	*1985/86*	*1986/87*	*1987/88*	*1988/89*
Economic Management (July 1984)	3	−1	–	–	–
Current Economic Situation (December 1985)		1	-1.5	–	–
Treasury Forecasts (July 1986)		1.5	- 1	–	–
Current Economic Situation (August 1987)		–	2	-0.5	1.5
Actual Outturn	6.6	2.2	2.4	–	–

Source for Actual Outturn: Department of Statistics

Other indicators of overall demand pressures have also suggested that macroeconomic policies have been having a restraining effect: most measures of unemployment have been rising since mid- 1985, while the current balance of payments has improved steadily from 8.4 percent of GDP in 1984/85 to 3.9 percent of GDP in 1986/87. Both trends are expected to continue during the coming year.

The broadly restrictive policies of the last three years have resulted in some success in reducing inflation, but progress has been somewhat uneven and less rapid than would be desirable. As Table 4.3 shows, by mid- 1985 all measures of inflation were running close to 20 percent at an annual rate. The effective assertion of tight monetary policies following the float of the exchange rate resulted in a rapid improvement as producer input prices nearly stopped increasing altogether during the latter part of 1985. Producer output price inflation slowed to around 5 percent per annum and the rate of increase in consumer prices dropped to around 10 percent. During 1986, however, the high wage round at the end of 1985, even though partially absorbed by lower profit margins, prevented the slowdown in input prices from being fully reflected in output prices. As inflation of input prices increased during the course of the year, a general picture of inflation having stabilised in the area of 10 percent emerged. If anything, it was rising.

TABLE 4.3: Producer and Consumers Price Inflation (percentage changes in levels over proceeding 6 months at an annual rate)

Quarter	Producer Price Index: *Inputs*[1]	Producer Price index: *Outputs*[1]	Consumer Price Index	
March 1985	19.2	16.5	16.1	
June 1985	19.0	17.7	20.3	
September 1985	12.8	13.1	16.6	
December 1985	1.1	4.7	10.4	
March 1986	2.7	5.6	9.5	
June 1986	5.9	10.4	10.4	
September 1986	4.7	9.0	12.6	
December 1986	8.2	9.6	26.7	(13.8)*
March 1987	9.7	11.1	24.3	(11.0)*
June 1987	na	na	11.7	(10.6)”

‘All market groups

‘Figures in brackets are adjusted for assumed GST effects of 5.5 percent in the December 1986 quartet, 0.3 percent in the March 1987 quarter, and 0.2 percent in the June 1787 quarrer.

na Nor available

Source: Departmenr of Statistics

Following the firming of liquidity conditions late in 1986 the rising trend in consumer price inflation appears to have been arrested and the outlook for the next two years is for the declining trend to be re-established. The main contributing factors are the favourable outturn to the last wage round, the relative strength of the exchange rate, which has recovered by around 10 percent since September, and the stability of world prices. On the technical assumption that the real exchange rate will remain unchanged from its average for the March 1987 quarter, inflation as measured by the annual increase in the consumer price index is forecast to fall to around 9 percent by the end of 1987 and to around 7 percent during the year to March 1989.

The assessment of inflation developments and prospects has been complicated by the effect of changes in the tax system, which have one-off effects on prices but with uncertain timing and whose extent are difficult to identify. GST has been the most important of these, but removals of subsidies, abolition of wholesale sales tax, reductions in tariffs and adjustments in excise taxes have also resulted in nonrecurring changes in prices. On balance these changes have involved a marked shift toward reliance on indirect taxation. Looking ahead, however, indirect taxes net of subsidies are expected to increase by only 2 percent nexr year. The result has been that indirect taxation and subsidies have had a large positive knock-on effect on prices since 1985/86 as indirect taxes have risen far more rapidly than incomes while subsidies have been phased out. Over the next year or so they will act as a restraining force.

Since GDP can be measured in two ways-at 'market prices', which takes account of the behaviour of indirect taxes and subsidies, and at 'factor cost', which excludes indirect taxes and subsidies-it is possible to get an indication of the impact of indirect taxation by comparing the rates of increase of the 'deflators', or implicit price indices, for these two measures. Little public attention is normally focussed on these measures because they exclude some items that are important in household budgets, notably mortgage interest payments and second-hand goods. They are also available only on an annual basis and appear only afrer a considerable time lag (the figures in Table 4.4 are Treasury estimates and forecasts for the period from 1986/87). However since their coverage extends to all of a country's output, including investment expenditures and purchases made by the Government, they are probably the best measures of inflation available.

TABLE 4.4: Inflation as Measured by the GDP Deflator*
(percentage increase over previous year)

Year ending March	*GDP Measured at Market Pricer*	*GDP Measured at Factor cost**
1979	13.1	13.4
1980	13.9	13.1
1981	15.5	15.1
1982	15.7	16.1
1983	11.3	11.0
1984	7.3	6.5
1985	6.7	5.6
1986	13.5	13.8
1987	13.9**	11.9**
1988	12.7**	7.8**
1989	5.9””	6.9”’

'GDP at factor cost is equal to GDP at market prices less indirect taxes plus subsidies. The GDP deflator is an implicit price index derived by removing that part of the percentage increase in the value of GDP which represents an increase in the volume of GDP.

**Treasury estimates and forecasts.

Source: Department of Statistics

Normally, the two measures move in broadly parallel fashion, as they did until 1985/86 (see Table 4.4). When there is an important change in the reliance on indirect taxes, however, the measures diverge. Over the two years to 1987/88, the first year when a full year's GST will be collected, the market price measure' will have risen cumulatively by around 7 percent more than the factor cost measure. It should be stressed that this figure does not only reflect the impact of GST but also that of all other changes in indirect taxes and subsidies. During the next year, however, with indirect taxation acting to restrain inflation, the market price measure is expected to rise by 1 percent less than the factor cost measure. The result is that the factor cost measure suggests a clear downward trend in underlying inflation since 1985/86, but the market price measure, which moves broadly in line with the politically sensitive consumer price index, will not reflect this until 1988/89, when it should fall off in an exaggerated way.

The uneven pace of disinflation to date highlights the importance of consistently directing monetary policy toward the objective of price stability and the difficulty of achieving this with a cautious approach. Moving more forcefully entails a risk of some further costs in the form of lost output and higher unemployment, but, if overseas experience is a guide, these costs are very difficult to avoid and they have been a feature of virtually all successful disinflation experiences, Perhaps the most striking feature that emerges from the table is the extent to which the costs so far experienced in New Zealand are below those which other countries have found necessary to reduce inflation. This is probably partly due to the benefits of liberalisation measures already undertaken, which have to some extent offset the costs of disinflation, and to some extent a reflection of the fact that the disinflation process still has a long way to go.

Concluding Remarks

After running at a rate close to 20 percent during the first half of 1985 inflation was reduced to around 10 percent at the end of 1985, where it currently remains. It appears likely to fall to around 7 percent over the next two years. Indirect tax changes, having worked to raise measured inflation since 1985/86, will increasingly act to restrain it. These projections are in line with most outside forecasts. This would be the best performance New Zealand has had in controlling inflation without resort to controls since before the first oil price rise in 1973. Progress, however, has been uneven. Inflation expectations, while improving recently, remain high and, to date, single-digit inflation remains a forecast rather than a result. Furthermore, inflation of 7 percent is far too high, exceeding that of all our main trading partners except Australia by a substantial margin.

The principal lesson of the past three years' experience is the importance of ensuring that price stability *consistently* takes priority over other objectives in the formulation and implementation of monetary policy. While it is desirable to mitigate the costs of adjusting to a low inflation environment, a bias toward excessive ease can easily emerge if doing this displaces price stability as the goal of policy. The effect of allowing this to happen is likely to be perverse, because by weakening the credibility of the Government's commitment to disinflation, high inflation expectations will be reinforced rather than discouraged. Since the failure of inflation expectations to adapt to a non-inflationary monetary environment are the main source of adjustment costs of disinflation, this will act to raise the costs which are ultimately necessary. In contrast, clear evidence that the Government intended to move forcefully and rapidly to complete the disinflation process notwithstanding the costs, would reduce these costs by enhancing the credibility of the commitment to price stability, and favourably affect expectations. The reassertion of clearly restrictive monetary conditions late in 1986 despite the imminence of an election contributed a great deal in this area. A further clear indication from the Government now that there will be no reversal on disinflation and that, if anything, its pace will be accelerated would reinforce the improving trend of inflation expectations that has been evident since April. It would also increase the likelihood that the forthcoming wage round will be consistent with demand conditions.

While disinflation is fundamentally a matter of persevering with restrictive monetary policies, it is important that other Government policies are supportive.

- Fiscal consolidation is important on two counts. First, it will reduce government demands on financial markets, which will tend to spread the burden of adjustment away from investment and exports toward consumption. Second, by reducing the likelihood of excessive debt accumulation it will have favourable effects on expectations.
- Reductions in border protection would reduce the prices of imported consumer goods, and more generally increase the scope for competition in domestic markets. It would also lower producers' costs. Furthermore, by allowing a non-inflationary monetary policy to be consistent with a lower real exchange rate it would ease the burden that has been born by exports.
- Further labour market reform would facilitate smoother and less costly adjustments.

MONETARY ARRANGEMENTS : THE EXCHANGE RATE REGIME AND LIQUIDITY MANAGEMENT FRAMEWORK

Introduction

Monetary arrangements comprise the institutional framework that determines the terms and conditions on which cash is made available to the economy. Since the role of monetary policy is to deliver price stability it is important that monetary arrangements facilitate this goal, They may do this either by putting automatic mechanisms in place which give the system self-stabilising properties consistent with price stability or by creating incentives which will lead Ministers and officials to ensure that discretionary policy adjustments are consistently directed toward that end. It is also desirable that they facilitate rapid and efficient adjustments to changes in the economic environment as they are required.

The arrangements that were in place in July 1984, were the cumulative result of a series of ad hoc changes that had been made in previous years. A web of regulations and controls largely had the objective of avoiding timely adjustments rather than making them quickly and efficiently.

The monetary authorities frequently operated the system to achieve goals other than price stability. This chapter reviews the substantial progress that has been made during the past three years in reforming monetary arrangements and suggests some directions for continuing the process. Since the choice of an exchange rate regime is one of the most important decisions that must be made in creating efficient monetary arrangements the chapter is divided into two sections. The first reviews the decision to abandon the pegged-exchange rate regime for a freely floating regime in March 1985 and assesses the experience with it. Broadly, the experience has been highly favourable. The second section reviews the evolution of the liquidity management system within which monetary policy is now formulated and implemented and provides an assessment. Since the system that has evolved relies heavily on flows to and from the public account it is assessed both as a monetary control framework and as a banking arrangement for the Government. Our conclusion is that both the Government's banking arrangements and the monetary control framework could be improved by separating them and moving toward a cash-oriented monetary control system. This would simplify and enhance the transparency of monetary policy while allowing the Government to make its banking arrangements with a view to managing its finances more efficiently.

The Exchange Rate Regime

The Decision to Float

The main consideration leading to the decision to float was the likelihood that floating would provide more certain price signals to market participants during a period of considerable change. While confidence in the stability of the exchange rate, other things being equal, was likely to be beneficial for those exposed to international trade, the comparison was nor simply between a free and a fixed rate. Any regime requires real adjustments over time. These adjustments may come through changes in the nominal rate or through movements of the overall price level to alter the real rate. Given the large fiscal and current account imbalances that existed at the time of the decision, and the substantial programme of reforms being undertaken, it was clear that there was considerable potential for adjustments to be necessary. Less clear, however was the direction, size and the profile of the required adjustments-evidenced at least in part by some people's expectations that the exchange rate would depreciate following the float.

A floating exchange rate relieved the Government of any requirement to attempt to assess the appropriate timing and size of discrete rate adjustments. It was therefore perceived as likely to lead to more accurate and rapid adjustment than a fixed exchange rate. In addition, it eliminated the potential for speculative profits to be made from anticipating adjustments correctly at the expense of taxpayers.

Experience with Floating

A major concern at the time of the float was the ability of the local market to cope with the increased pressures. Market development, in terms of depth, expertise and capitalisation, has been considerable in the relatively short period since the float. Levels of turnover on the New Zealand dollar in the spot market are now of the order of $5.5 billion daily, around five times the level at the time of the float. A further important aspect of the development of an effective foreign exchange market has been the development of an efficient forward market. Daily turnover in this market for the New Zealand dollar is now around $1.8 billion, compared with $200 million before the float. This development can also be seen in the total number of contracts outstanding (both buy and sell)-up from $29 billion in February 1985 to $72 billion in June 1787.

The second area of concern about the performance of the floating rate regime which is frequently expressed is that it results in excessive variability in the level of the exchange rate. In assessing this issue, it is useful to distinguish between short term volatility and medium term swings. Short-term volatility is rhe degree of variability in nominal exchange rates from day-to-day, week-to-week or month-to-month. Table 4.5 provides an indication of how the volatility of the New Zealand dollar over very short periods compares to that of some other floating currencies. It reports the standard deviation of weekly percentage variations from the mean in exchange rates against the US dollar over a two year period from March 1985. The New Zealand dollar has displayed only marginally more short term volatility than the German mark or Japanese yen, and about the same as the British pound and Australian dollar.

TABLE 4.5: Short Term Exchange Rate Volatility (standard deviation of weekly percentage variations from the mean against the US Dollar March 1985—Feb 1987)

New Zealand Dollar	*German Mark*	*Japanese Yen*	*British Pound*	*Australian Dollar*
1.77	1.41	1.36	1.77	1.72

Source: Reserve Bank

The costs of short-term volatility of exchange rates are widely thought to lie in alleged adverse effects on trade due to risk. These costs have been analysed in a number of studies, notably by the International Monetary Fund and the Bank of England. These studies have broadly concluded that while short term exchange rate volatility may be a nuisance, it is not a serious problem, and not a matter for policy concern, provided there are no impediments to hedging in the form of exchange controls. In New Zealand, since the abolition of exchange controls, the foreign exchange market has shown very rapid development. It is still proceeding in terms of the numbers of dealers and volumes and instruments traded, and corporate traders now have access to a wide variety of instruments for managing exchange rate risk. We see no reason to believe that short term exchange rate volatility is a problem.

Medium term swings in exchange rates refer to movements in exchange rates which persist for a sustained period, perhaps for several years, and reverse only in the longer run. The rises of the British pound during 1979–8 1 and the US dollar during 198 l-85 and their subsequent falls are the best known examples internationally. The swings in the New Zealand dollar have been far less pronounced and of shorter duration, but have nevertheless led to some public concerns being expressed.

In assessing the extent to which this is a problem it is important to recognise that exchange rates are prices determined in financial asset markets and reflect the interaction of a wide range of forces:

— by directly influencing the rate of return on financial assets, fiscal and monetary policy shifts can cause large movements in exchange rates. The Government can ensure that its own financial policies are a stabilising influence by ensuring that a steady non-inflationary monetary policy stance is maintained and that it is consistently supported by fiscal policy. The swings in the exchange rate since the float have, to a considerable extent, reflected fluctuations in the degree of disinflationary pressure being applied by monetary policy.

— Non-financial factors affect exchange rates. These include both non-policy developments such as technological innovations, changes in consumer demand patterns, divergent productivity movements across countries, and natural resource developments. As these change, they are reflected in exchange rate movements which facilitate desirable adjustments. The Government's structural policies, such as the regulatory environment and border protection, are also reflected in exchange rates. If macroeconomic policies are sound but the exchange rate that results still appears to be unsatisfactory, say, because it discourages exports, the solution lies in improved structural policies, such as the need for further reductions in border protection.

— Since the returns on financial assets are importantly influenced by expectations, any new expected future developments can quickly affect the exchange rate. This is desirable, as new information is quickly reflected in the exchange rate and therefore influences economic decision making at an early stage. Since the exchange rate will quickly reflect the markets' assessment of the Government's policies it is important that confidence in the soundness of the fiscal position and the credibility of a non-inflationary monetary stance be maintained at all times.

In summary, there are no serious problems inherent in a floating exchange rate regime and to date the experience in New Zealand has been good. We see no need for further reforms in this area. The depth and breadth of the market have increased and corporate traders have become increasingly adept at managing the short-term risks associated with floating. The level of the exchange rate is a reflection of underlying economic forces, both policy and non-policy, and any instability over periods longer than a few weeks or months is a symptom of instability elsewhere in the economic system, either in New Zealand or overseas. Exchange rate movements reflect underlying economic developments and changes should be seen as desirable signals which will facilitate necessary adjustments. The

Government can contribute to stability by ensuring that its own policies are stable and that confidence in their soundness is maintained. If the level of the real exchange rate which emerges is perceived to be stronger than desirable, structural policies, notably high levels of border protection which serve to discriminate' against overseas trade, should be reformed.

THE LIQUIDITY MANAGEMENT FRAMEWORK

Evolution Since July 1984

By July 1984 the financial system in New Zealand was one of the most heavily regulated systems in the world. A wide range of interest rates was subject to extensive and detailed controls, guidelines were in force to restrict banks' lending to the private sector. A reserve asset ratio system was in place to provide a captive market for government securities and to assist with monetary control. During the next nine months a series of liberalisation measures was put in place which has left New Zealand with one of the most open and unregulated financial systems in the world. The measures included the following:

- removal of controls on interest rates;
- withdrawal of the special status of the four official short-term money market dealers;
- abolition of quantitative guidelines applied to monthly lending by the main financial institutions;
- removal of controls on all outward and inward foreign exchange transactions;
- removal of reserve asset ratios;
- float of the dollar;
- liberalisation of criteria for entering into the banking industry and issuance of eight new banking licenses.

The deregulation of the financial system has had two important effects. First, credit allocation is now done by markets, via the price mechanism, rather than administratively. This has meant that monetary control has had to rely on market oriented methods rather than guidelines and controls. As a result, interest rates have had to adjust more to achieve a given degree of monetary restraint than in the past, when restraint was partly achieved by allowing waiting lists for credit to lengthen. Second, the New Zealand financial system has become highly integrated with the international financial system. This has meant that the exchange market responds rapidly to changes in monetary conditions and sentiment in financial markets. A new constituency for non-inflationary policies in the form of international financial markets has effectively been created.

The deregulation of the financial system obliged the Reserve Bank to develop market-oriented procedures for ensuring monetary control. -The floating of the exchange rate, which relieved the Bank of the commitment to create or destroy cash by intervening in the exchange market, gave the Bank the freedom to make this control effective. While the changes in the Bank's procedures took place gradually, the present system has been in place since April 1786. Its principal features are:

— cash injections from the public account or the Reserve Bank's own transactions are fully funded by sales of government stock;

— seasonal variations in the Government's financing needs are met by issues of Treasury bills;

— the Reserve Bank conducts open market operations on a daily basis with a view to providing the banking system with a target amount of settlement balances (currently $30 million) after all needs for cash are met;

— if the Reserve Bank's forecast of the system's cash requirement is wrong and the banking system is short, the Bank is prepared to discount Treasury bills or government stock with less than 30 days to maturity;

— the interest rate at which the Reserve Bank discounts short-dared government securities floats with market rates, is at a slight premium over Transferable Certificate of Deposit (TCD) rates;

— the Reserve Bank pays interest on settlement balances held by banks at 65 percent of the seven day TCD rate.

The cutting edge of this system of monetary control is the need for banks to settle with the Reserve Bank when there are net flows to the Government. While the Bank provides enough cash to cover anticipated requirements, forecasting errors occasionally occur and banks must ensure that they can always settle. This means that they must hold enough cash or discountable securities to cover all eventualities. By controlling the supply of 'primary liquidity', that is, settlement balances plus discountable securities, the Bank can ensure that liquidity conditions remain as tight as desired.

Since the liquidity management system that has evolved relies heavily on flows to and from the public account the following sections provide an assessment of it first as a monetary control framework and second as a banking arrangement for the Government. Our conclusion is that both the Government's banking arrangements and the monetary control framework are adversely affected by their integration. The final section suggests how both could be improved by separating them and moving toward a cash-oriented monetary control system. This would simplify and enhance the transparency of monetary policy while allowing the Government to make its banking arrangements with a view to managing its finances more efficiently.

Assessment of the System as a Monetary Control Framework

Chapter 1 emphasised the importance of a stable environment for economic decision making in which information costs and uncertainty are minimised. The Government can contribute to creating such an environment by ensuring that its own activities are not a source of uncertainty. In the context of monetary policy this implies:

i that the objective of policy, that is, medium term price stability, should be pursued steadily and consistently; and

ii that the implementation of policy should be as transparent as possible.

These will be greatly facilitated if the monetary authorities can identify a useful 'intermediate target' which will act as an 'anchor' for nominal magnitudes in the system. This must be a financial variable which can be controlled with a reasonable degree of accuracy and to which money incomes, and hence prices, will tend to adjust over the medium term. If such a variable can be identified, the monetary authorities can formulate policy in terms of it in the knowledge that this will achieve their objective, and by announcing their intentions publicly, they ensure that the market can fully anticipate their actions. In the process the market is provided with a basis for assessing the authorities' performance in financial terms, which can favourably affect the authorities' incentive to adhere consistently to their price stability objective.

Given a floating exchange rate, the role of nominal anchor must be played by a monetary aggregate. It would be desirable to find a monetary aggregate whose growth could be suitably restrained by the Reserve Bank with a reasonably predictable effect on inflation over the medium term. At present, primary liquidity to some degree plays that role. A demand for primary liquidity exists because settlement institutions must always have discountable securities or settlement balances in order to settle with the public account in the event that the Reserve Bank underestimates the system's need for cash. This implies that restraint of the medium term growth of primary liquidity will give the system stabilising properties in the face of disturbances to the price level. If prices rise faster than primary liquidity its real value falls. This leads settlement institutions to bid more strongly in the interbank market for cash and discountable securities, tightening monetary conditions. The higher interest rates that result have a deflationary impact on spending, which in turn has a restraining effect on prices. The Reserve Bank can also control the supply of primary liquidity directly with a reasonable degree of accuracy, without the aid of distorting regulations such as cash reserve requirements, by setting the maturities of new issues of Treasury bills and by operating in the open market.

This system has the desirable feature of relieving the Reserve Bank of the need to fix or adjust interest rates explicitly. In addition, the policy of daily open market operations to provide the system with a target level of settlement balances contributes to transparency by providing the market with a clear basis for anticipating the Reserve Bank's day-to-day behaviour. However, experience with the system has not been entirely satisfactory.

First, primary liquidity is normally held almost entirely by settlement institutions, whose demand relates to the variability of the Government's daily cash flows and the Reserve Bank's ability to forecast them. While there is no question that by controlling the supply of settlement cash and discountable securities the monetary authorities can make monetary policy effective, the connection between primary liquidity and money incomes and prices may be loose. Settlement institutions' demand for primary liquidity will be influenced by factors such as changes in the tax system or government payment practices, corporatisation of government trading departments and improvements in the Reserve Bank's forecasting ability. This suggests that their demand for primary liquidity is unlikely to bear a strong or stable relationship to either the size of their own balance sheets or an aggregate such as M3 (the broad measure of money supply). Even if they did, a good link between these and money incomes or prices would be required to establish such a connection between primary liquidity and inflation. However, given the effects of deregulation of the financial system on the public's behaviour and continuing institutional change, there are reasons for doubts on this score.

Second, primary liquidity is not a simple, homogeneous aggregate, since the likelihood of having to discount is influenced by the size of the cash component, that is, the Reserve Bank's daily cash target, and the cost of discounting is influenced by the maturity structure of discountable securities. This serves to reduce the transparency of a monetary policy based on controlling primary liquidity.

Third, there is no constraint on any aggregate which is held by the non-financial sectors who make the bulk of decisions concerning spending and wage and price formation. In particular, controlling primary liquidity implies no constraints on the total amount of cash which is issued because it excludes notes and coin in circulation with the public.

The result has been that, in practice, discretionary adjustments in policy settings have been required in light of officials' judgement about the appropriateness of a range of economic and financial indicators. Such judgemental adjustments make it difficult for the authorities to avoid some responsibility for the behaviour of financial indicators, however formally market-determined they are. They also generate costs in the form of effort by financial markets to understand the monetary authorities' thinking in some detail because a premium is created on being able to anticipate both the substance and timing of their actions.

To summarise, present arrangements provide a framework which allows the authorities to make their policy intentions effective with little difficulty. Provided monetary policy is directed consistently at the objective of price stability there is no reason why it cannot deliver successful disinflation (and, as the previous section on disinflation makes clear, available evidence indicates that this is occurring). However, the need for judgemental adjustments by the monetary authorities limits the system's transparency and generates costs in the form of efforts to cope with uncertainty by financial markets.

Assessment of the System as a Banking Arrangement for the Government

An imporrant feature of the Government's activities is that these include the handling of large amounts of money. The funds which the Government raises, either through taxation or borrowing, must be transferred to the departments who will spend them. Since the timing of revenues is not closely aligned with the riming of disbursements, substantial fluctuations can occur in the public account. This requires cash management. The Government also has a large outstanding debt and a portfolio of financial assets, both in New Zealand and overseas, and these must be managed. It is desirable to manage all this money as efficiently as possible since inefficient management would imply either waste of real resources or an unnecessary transfer from the taxpayer to private financial market participants. The present arrangement limits the scope for doing this in a number of ways.

First, it is doubtful that the banking services the Government receives are being provided as efficiently as possible. Since flows to and from the public account provide the fulcrum on which monetary policy is made effective, the criteria the monetary authorities use when making operating decisions which affect the Government's banking often relate to monetary policy rather than customer satisfaction. Furthermore, since the Reserve Bank holds a large portfolio of income earning assets which are funded by note issue, providing revenues of the order of $150-200 million at today's interest rates, it faces no effective budget constraint. In addition, it faces neither a market test nor a need to justify its use of funds in the budget appropriation process. It therefore has little direct incentive to minimise its costs. Finally, the priority which must be attached to monetary policy means that the Government is constrained in its ability to make alternative banking arrangements in the absence of a change in the monetary control framework. The Reserve Bank therefore has lirtle incentive to offer rhe best possible banking service.

Second, since the Reserve Bank Act precludes the Reserve Bank from charging the Government for banking services relating to the operarion of the Public Account, the Government does not explicitly face the full costs of these services. This means that it has no incentive to arrange its finances efficiently in order to reduce its demands for banking services (for example cheque clearing) to levels where the value of the services exceed the real costs of providing them.

Third, the Government's flexibility to operate in financial markets is limited on two counts. The first limitation arises from the role of Treasury bills as monetary policy instruments. The amounts of Treasury bills issued and their maturity dates are currently set with a view to controlling primary liquidity with monetary policy considerations in mind. Since monetary policy considerations at any one time are influenced by any transactions the Reserve Bank is expected to carry out on its own account (for example sellbacks), the quantity of Treasury bills issued may differ from the Government's own immediate needs. The maturities which are desirable for monetary policy purposes may differ from those which officials would choose if they were attempting to find the most efficient approach to debt servicing from the point of view of minimising cost and risk. At present, Treasury bill sales may at times result in borrowing for longer periods than necessary with the result that idle balances accumulate in the public account, while the Government is deprived of a short-term instrument to assist the management of risk in its overall portfolio.

The second limitation is that the Government is not free to manage the public account actively because this might interfere with simultaneous maintenance of an effective monetary policy and stable financial condition. If the public account were managed in such a way as to reduce the randomness of its daily flows significantly, which might make the interbank market function more smoothly, settlement institutions' demand for primary liquidity would tend to fall, undermining the effectiveness of monetary policy. On the other hand, if the public account were managed in such a way as to make the flows more erratic, concerns would arise about volatility of interest rates and the impact on financial markets.

DIRECTIONS FOR THE FUTURE

The present liquidity management framework fulfils two quite separate functions. First, it provides a basis for monetary policy, that is, the framework in which the

Reserve Bank sets the terms and conditions on which it makes cash available co the economy. Second, it provides the Government with the banking services it needs to manage its cash needs on a day-to-day basis. By separating these functions it should be possible to simplify monetary policy and enhance its transparency while at the same time improving the Government's banking arrangements and its ability to manage its finances efficiently. Any such separation would clearly have implications for the role and structure of the Reserve Bank, and would require changes in the Act under which the Reserve Bank operates. The Act requires the Bank to have multiple, and often conflicting objectives. As such, it makes it difficult to assess the Bank's performance and weakens the scope for holding the Bank accountable. Reformed arrangements that recognise, and to the extent possible, institutionalise, medium term price stability as the appropriate role of monetary policy should assist in enhancing the credibility and effectiveness of monetary policy.

Monetary Policy

We consider that serious thought be given to moving towards a system which focuses explicitly on controlling the growth of total cash liabilities of the monetary authority (the 'monetary base'). These cash liabilities consist predominantly of notes and coin but would also include any deposit liabilities of the monetary authoriry which would be issued at most to banks. Separating the Government's banking arrangements from the monetary authority, so that transactions with the public account no longer affect the amount of cash in the system, would eliminate the contingent liability to create cash by discounting short-dated securities. This would simplify the control of the amount of cash which is issued. By ending the present practice of passively accommodating the public's wishes to convert bank deposits into cash by simply printing more bank notes and conducting open market operations to restore the banking system's holdings of cash, direct control of the amount of cash on issue would be established.

Such a cash based system would provide the desired anchor to nominal magnitudes by requiring banks to maintain a reserve to ensure they could always meet their obligations to provide cash when customers wished to make withdrawals. The expansion of the money and credit aggregates, and the financial system more generally, would tend to be restrained because the inflationary consequences of any excessive credit creation would cause the public to withdraw more cash from the banking system for its day-to-day needs. This would deplete banks' reserves, leading them to push interest rates up by bidding for cash in the money market, and to restrain their lending activities until the cash drain stopped. Since inflation can continue only to the extent that the monetary authorities accommodate it by increasing the amount of base money they issue, control of the monetary base would force the banking system to expand its activities in a manner consistent with reasonable medium term price stability.

There would be several advantages of proceeding in this way. First, by limiting monetary policy to explicit decisions to issue cash, transparency would be enhanced. Second, the bulk of cash outstanding is held by the non-financial sectors, who make virtually all of the economy's decisions concerning spending and formation of wages and prices. The link between inflation and the supply of cash is therefore likely to be better than that between inflation and the supply of primary liquidity, which is held almost entirely by members of the Databank system. The greater reliability of the link to inflation with a cash-based system implies that less discretionary management would be required than at present. Third, the interbank market would function more smoothly with monetary policy no longer reliant on uncertainty about daily flows to and from the public account. The public account could be managed commercially, which would create an incentive for the Government to reverse the seasonal tax flows which can cause unsettled conditions if they are unexpectedly large (as in during March 1987) rather than accumulating idle cash. At the same time, transactions with the public account could clear through the Databank network as expeditiously as possible without any fear of creating excessive monetary easing.

The Government's Banking Arrangements

If monetary arrangements are established along the lines described above, the Government could seek banking arrangements which best suited its needs. It would be desirable to put these arrangements on a fully commercial footing, with the Government facing the full costs of providing it with banking services. This cannot be done at present since the Reserve Bank Act prohibits the Bank from charging the Government for services relating to the Public Account and the Government is limited in its ability to move its banking elsewhere.

With public account transactions no longer having a monetary policy impact the Government's banking arrangements could be organised to facilitate the efficient management of its finances. Given that the Treasury bill would no longer have a role as a monetary policy instrument, the development of an integrated treasury function for the Government's financial assets (mainly the overseas reserves, debts and day-to-day cash flow) largely according to more commercial criteria would be enhanced. More generally, it would facilitate improvements in incentives for more effective management within the public sector.

The first step in putting the Government's banking arrangements on a commercial footing should be that the present arrangement with the Reserve Bank in which the Government receives 1 percent interest on the public account, pays 1 percent if the public account is overdraft, and does not pay for any other services, would have to be changed. At present, we do not have a good idea of what costs are involved in providing the Government with its present range of banking services, whether present arrangements are the most efficient way for the Government to manage its day-to-day finances, or what alternative arrangements would make more sense. Some possible changes, however, would include payment of a market related interest rate on overdrafts, payment of service charges related to the volume of transactions involving the public account, arrangement of stand-by lines of credit, and/or receipts of interest on deposits whose rate moved with market rates but whose margin below market adequately reflected the cost (to the Bank) of handling the Government's transactions.

Finally, if the most efficient banking services for the Government are to be found it is important not only that the Government be allowed greater choice in where it banks but also that these services not be uoss-subsidised by other activities so that the Government faces their full cost.This would make it important that the Reserve Bank be required to account separately for the different activities it now undertakes and to charge the full costs for those services which are of a commercial nature.

FISCAL TRENDS

Introduction

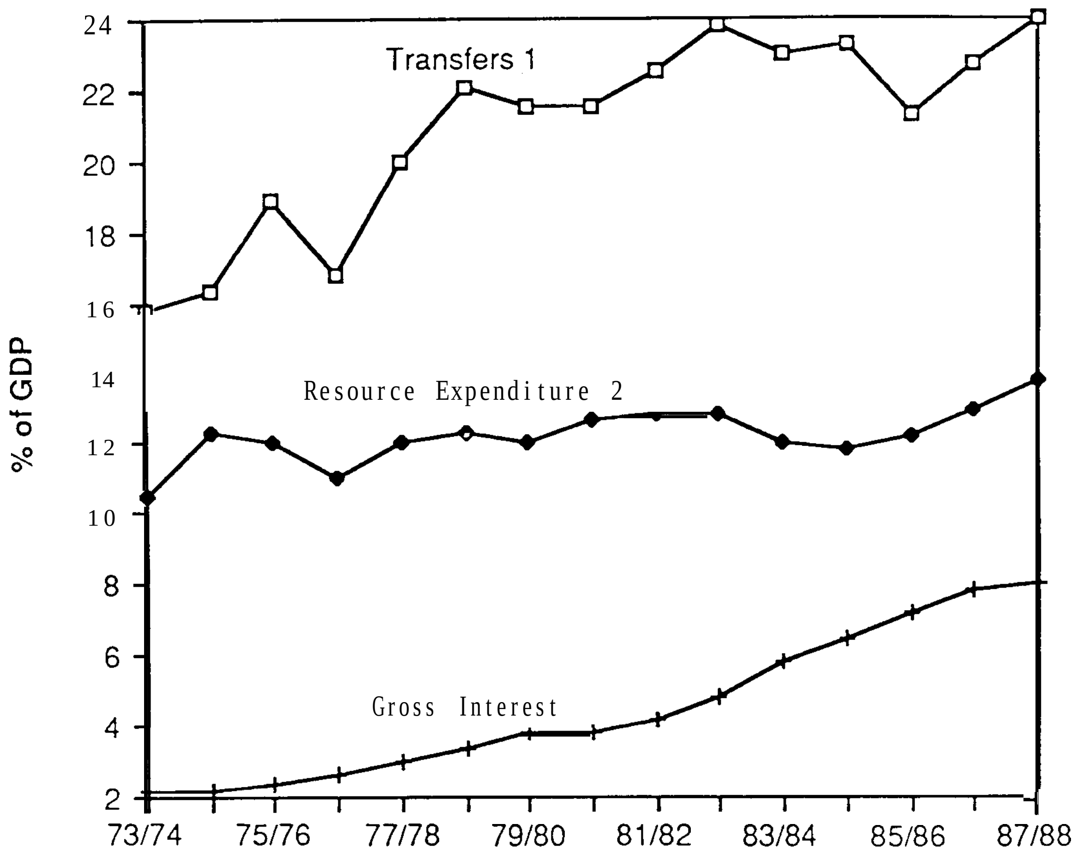
This section discusses trends in expenditure, tax burdens, revenue and deficits since 1973/74.

Expenditure

Total net government expenditure (Government Financial Statistics basis) including net lending has risen steadily as a share of GDP from 3 1. I percent in 1973/74 to reach 43.6 percent in 1986/87. It is forecast to be 43.7 percent in 1987/88.

This growth in public spending does not reflect an increased demand for real goods and services. Real government resource expenditure as a percentage of real GDP has remained remarkably stable over the period from 1973/74. Rather the

GRAPH 4.1: Selected Expenditures (%GDP)



'Includes capital transfers.

'Includes wage and salaries, goods and services, and capital expenditure.

Sources: Government Financial Statistics (GFS) data, Nominal GDP- Department of Srarisrics estimates and Treasury forecasts

growth in public spending mainly reflects the growth in two types of current non-resource expenditure-interest payments and other transfers (see Graph 4.1).

The growth of transfer payments primarily reflects two sets of factors-first the increase in coverage of transfer payments with the introduction of National Superannuation and the Domestic Purposes Benefit and second, the growth in unemployment payments. The growth in debt servicing (on both a gross and net basis) reflects both the impact of a succession of fiscal deficits on the stock of debt and more recently the high level of interest rates. There is no evidence that this growth is due to government expenditure being devoted to capital items. Government investment and net lending expenditure have fallen markedly as a share of GDP.

TABLE 4.6: Trends in Expenditure (percentage of GDP)

	1973/74	1979/80	1984/85	1986/87	1987/88 Forecast
Wages and Salaries	6.6	7.9	6.9	7.5	7.7
Goods and Services	1.7	2.4	3.3	3.9	4.8
Capital (less Transfers)	2.4	1.7	1.6	1.7	1.8
Total Resource Exp.	10.6	11.9	11.8	13.0	14.3
Interest Payments	2.2	3.9	6.5	7.8	8.0
Transfers	15.8	21.5	23.5	22.6	24.3
Net Lending	2.7	3.1	2.0	0.2	-2.5
Total Expenditure (Incl. Net Lending)	31.1	40.4	43.8	43.6	43.7
Total Expenditure (Excl. Net Lending)	28.5	37.2	41.8	43.4	46.5

Sum-es: Government Financial Staristics (GFS) data Nominal GDP-Department of Statistics estimates and Treasury forecasts

Table 4.6 shows trends in selected measures of expenditure. Because of the number of major changes in the public sector over the last three years, considerable care is required in interpreting recent expenditure and revenue trends. For example total expenditure including net lending has been stable as a percentage of GDP since 1984/85 while total expenditure excluding net lending has grown. Annex 2 of the 1987 Budget discusses this issue more fully.

In the past expenditure as a percentage of GDP has been used as a measure of the tax burden. The tax burden is the amount of government spending that must be funded from taxation now or in the future. There are a number of factors which limit the usefulness of the expenditure to GDP ratio as a measure of the tax burden. Briefly these factors include:

— expenditure does not include assistance delivered through the tax system as so-called tax expenditures;

— expenditure includes capital expenditures, such as net lending, which result in current revenues from sources other than taxation;

— expenditure is affected by factors such as increased charging between departments and increased expenditure on GST which are regained through offsetting increases in revenue; and

— measured GDP is affected by the introduction of GST.

An alternative benchmark against which to assess tax burdens is private income. This aggregate provides a better measure of the taxable base. Analysis of the data in Table 4.7 when using this measure indicates strong growth in tax burdens over the 15 year period. However, although Table 4.7 does allow for accounting changes associated with the October 1986 tax 'benefit reforms, the data used makes no allowance for the phase out of tax expenditures. Table 4.7 suggests that, phase-out of tax expenditures aside, recent measures to review the effectiveness of expenditures have nor markedly slowed the growth in the tax burden.

TABLE 4.7: Expenditure Trends and Tax Burdens'

	1973/74	*1979/80*	*1984/85*	*1986/87*	*1987/88*
Total Expenditure ($m)	2,857	7,954	16,938	22,829	25,592
% of GDP	(31.1)	(40.4)	(43.8)	(43.6)	(43.7)
Less Net Lending	243	616	784	122	-1,649
Less Departmental Receipts' ($m)	62	148	349	929	2,263
Less Tax Reform Measures*			570	1,545	
Adjusted Expenditure ($m)	2,552	7,190	15,805	21,208	23,433
% GDP	(27.8)	(36.5)	(40.9)	(40.5)	(40.0)
% Private Income	(29.4)	(34.8)	(39.6)	(41.6)	(42.7)

'Departmental Receipts are the sum of administrative fees, charges and non-industrial sales; fines and forfeits; and other non-tax revenue.

'Source: Annex 2 of the 1987 Budget

'Note that no allowance has been made for the phase-out of tax expendirures.

Sources: Government Financial Statistics (GFS) data. Nominal GDP-Department of Statistics estimates and Treasury forecasts. Private Income-Treasury estimates and forecasts.

Revenue Trends

Although user charges and other revenue from non-tax sources have become a greater proportion of total revenue, taxation remains the main source of the Government's income. Total taxation as a percentage of GDP has been steadily increasing over the period from 26.1 percent in 1973/74 to 33.3 percent in 1986/87. This is forecast to rise further to 36.3 percent in 1987/88. However, as outlined in Annex 3 of the 1987 Budget, around half of the growth in 1987/88 reflects the changes in treatment of government expenditure.

The dominant trend in taxation over the period to 1984/85 was the growth in personal income tax, and in particular taxation on wage and salary incomes. Average tax rates, calculated from collections divided by total wage and salary payments, increased from 19.7 percent in 1973/74 to 25.5 percent in 1984/85. In contrast average tax rates on private operating surplus did not tend to rise over this period and indirect taxation, which was partly collected from specific excises, grew only slowly as a percentage of tax receipts.

The marked change in the structure of taxation since 1984/85 is shown in Table 4.8. The change mainly reflects the introduction of GST, together with the reform of other indirect and personal income taxes and company taxation. A separate section reviews taxation issues in more detail.

TABLE 4.8: Trends in Government Revenue (percentage of GDP)

	1973174	*1979/80*	*1984/85*	*1986/87*	*1987/88 Forecast*
Personal Tax	14.2	19.3	18.6	20.8	18.3
Company Tax	4.2	3.3	2.9	2.3	4.1
Indirect Tax	6.1	6.9	8.2	8.5	12.3
Other Taxes	1.5	1.0	1.2	1.6	1.6
Total Tax	26.1	30.6	30.8	33.3	36.3
Interest, profits and miscellaneous receipts	0	2.7	1.6	3.0	3.5
Total Revenue	26.1	33.3	32.4	36.3	39.7

Source: Budget Table 2 data. Nominal GDP-Department of Statistics estimates and Treasury forecasts

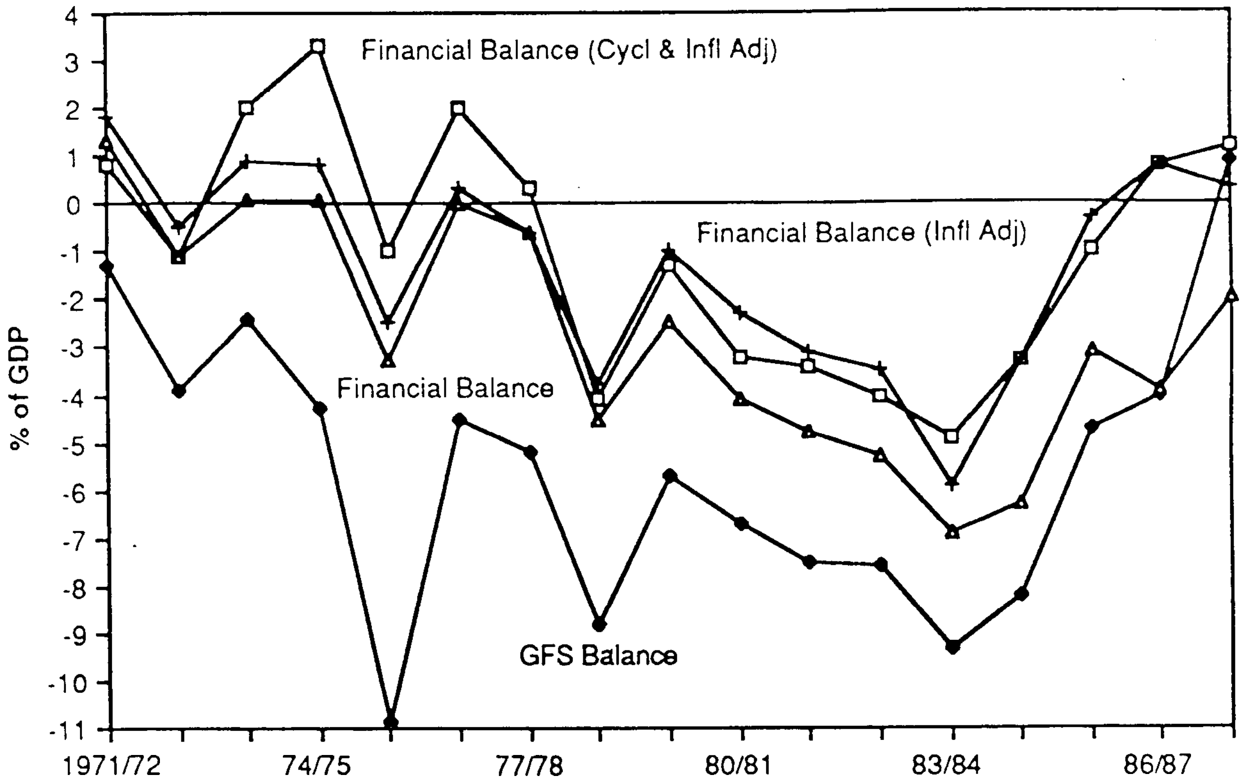
Deficit Trends

There are a number of different measures of the fiscal deficit available. The trends in the different measures were discussed in the Annexes to the 1986 and 1987 Budgets.

Graph 4.2, which is reproduced from the 1987 Budget, identifies movements in relation to GDP of the conventional GFS fiscal balance and financial deficit; excluding the impact of financing transactions. It also shows the financial deficit adjusted for cyclical factors and for the effect of inflation in eroding the real value of the Government's outstanding debt. All these measures show a marked deterioration in the fiscal position until 1983/84 and a marked improvement since then. The closure of the deficit has reflected the growth in revenue.

The conventional deficit (on a Budget Table 2 or a GFS basis) has been criticised on the grounds that the definition of the public sector is too narrow because it excludes the impact of government trading entities. Consolidated measures of the deficit such as Public Sector Borrowing Requirements (PSBRs) are proposed as alternatives. It is nor clear that these would provide a more

GRAPH 4.2: Selected GFS Measures of Fiscal Balance (%GDP)



Source: Budget 1987

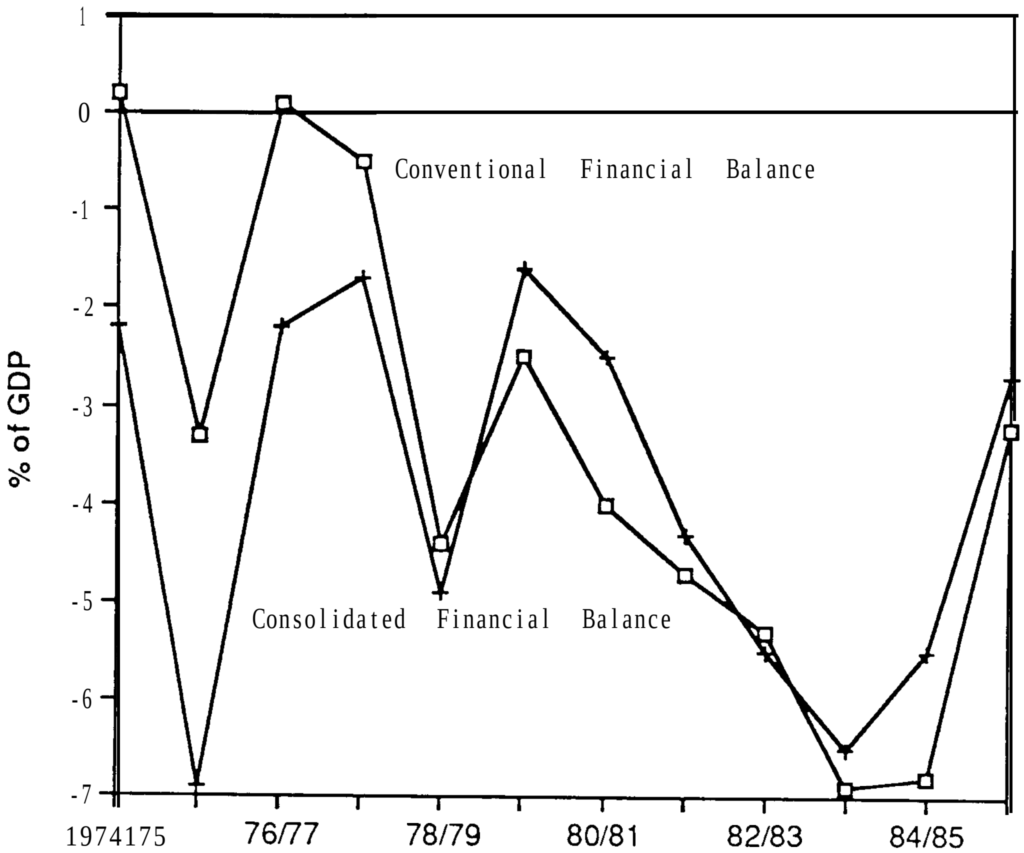
meaningful measure of the fiscal position. The economic impact of government trading organisations is similar to that of any other business as long as all decisions are made in a fully commercial manner. To the extent that this is the case, the focus on the consolidated deficit measure may be misleading.

Given the improved accountability that has resulted from the SOE process, rhe fiscal statistics for the core state sector should capture the cost of public policy. In the past, however, to the extent that government trading entities frequently pursued non-commercial objectives without being funded by explicit subsidies, a broader consolidated financial deficit may have provided a better measure of rhe borrowing costs associated with the implementation of public policy over the period, to say, 1986/87.

Graph 4.3 compares the GFS financial deficit of the core stare sector with Treasury estimates of the consolidated financial deficit of the wider state sector. This measure includes all entities that have majority central government ownership. The graph shows that the conventional GFS balance dominates the broader consolidated measure. Particularly since 1977/78, there has been a close correlation between measures. In the future it seems likely that a consolidated measure will, if anything, improve relative to the GFS balance. Two factors are expected to contribute to this:

— the phase down of the major projects construction and the capital works programme of Electricorp; and
— improvements in the profitability of SOEs as a result of their more commercial orientation.

GRAPH 4.3: Comparison of GFS and Consolidated Financial Deficit (%GDP)



Source: Conventional Balance as for Table 4.6. Consolidated Balance Treasury estimate

The Stock of Debt

A succession of past deficits has contributed to the growth in the stock of domestic debt for the core public sector. While this has been a feature of international experience generally since the early 1970s, New Zealand has experienced one of the sharpest increases in public indebtedness, relative to GDP, in the OECD area.

Table 4.9 presents trends in net government indebtedness for New Zealand compared to the OECD average. Net indebtedness (total financial liabilities less financial assets) is the most appropriate measure, as it represents the accumulation of borrowing by the Government to fund financial deficits. The table clearly shows that New Zealand is now one of the more highly indebted countries in the OECD.

TABLE **4.9: Trends in Net Debt (percentage of** GNP)

	1973/74	1979/80	1984/85	1985/86	1986/87
New Zealand					
Official	1.6	18.6	43.8	43.6	45.7
Local Authority	8.0	6.6	5.4	5.3	5.3
Total	9.6	25.2	48.9	48.6	51.0
OECD Average Net Debt	16.5	21.2	30.7	32.2	33.5
OECD Average for Small Countries	12.0	22.2	33.7	35.4	36.8

Sources: i New Zealand Official Net Debt: New Zealand Planning Council 'Tracking Down the Deficit' to 1985/86. Treasury calculations for 1986/87
ii Local Authority Net Debt: Department of Statistics Estimates 1985/6 and 1986/87 based on 1984/85 data
iii OECD

New Zealand's net official debt comprises net debt incurred by the central government and the Reserve Bank. The ratio of New Zealand's official net debt to GNP in 1985/86 at around 43.5 percent was about 10 percentage points higher than the OECD average general government net debt ratio. This comparison, however, understates the situation.

First, to make New Zealand debt levels comparable with statistics on other OECD countries, local authority debt must also be included. Figures on local authority debt beyond 1984/85 are not available, but it is likely that inclusion of local authority net debt statistics would add an average of over 5 percentage points to the New Zealand figure.

Second, the major project debt which the Government has taken over but not yet repaid is not included in official net debt figures. During the 1986/87 financial year the Government undertook extensive overseas borrowing in order to meet debt servicing payments on the major projects. Any borrowings not used to immediately repay debt have increased our overseas reserves. During 1987/88 most of the major project debt should be repaid, suggesting that official external reserves will decline. Accordingly, recorded official net indebtedness will increase.

Third, official indebtedness will also increase as a result of the likely need to write down financial assets associated with the Rural Bank and Housing Corporation restructuring and the likely absorption of some Railways Corporation and National Provident Fund debt associated with the restructuring of these entities. While decisions have yet to be taken on these issues, rough estimates suggest that net debt (including local authorities) is likely to amount to 60 percent of GDP by the end of the 1987/88 year. On this basis this makes New Zealand the fourth most indebted country in the OECD.

Conclusion

A review of fiscal trends since 1973/74 indicates a steady upward trend in expenditure levels and tax burdens. Driving these trends has been growth in transfer payments and debt servicing.

After steadily deteriorating between 1971/72 and 1983/84 the fiscal balance, as indicated by a range of measures, has improved significantly since 1983/84. This improvement largely reflects growth in tax revenue.

Reflecting a period of sustained fiscal deficits levels of public indebtedness have grown substantially.

FISCAL POLICY

Introduction

Fiscal policy is concerned with the use of government expenditure and revenue collection to affect the use of resources and distribution of income across the economy and through time. Government interventions with fiscal consequences are justified when they are the best means of improving the efficiency or equity of economic outcomes. There are, however, a number of limits to the use of fiscal policy. This paper outlines the role of fiscal policy and its limits. It then briefly reviews fiscal trends and examines in more detail the application of the principles discussed to expenditure, revenue, deficit and debt policies.

Fiscal Intervention

Chapter 1 identified a number of reasons why the role of Government extends beyond defining and enforcing the general rules that surround the operation of private interactions in markets. Two arguments can be advanced for the use of fiscal intervention. The first is that fiscal intervention can improve the efficiency of economic outcomes. Secondly, fiscal intervention can promote equity, interpreted broadly to include equality of opportunity, fairness of processes by which different social states emerge, and fairness of outcomes.

The key issue in contemplating any intervention is whether that action can improve the efficient operation of the economy or help the achievement of society's equity objectives better than some other intervention. While it is possible to identify a number of situations in which fiscal intervention might be justified, the difficulties in designing those interventions effectively and efficiently are substantial. These problems are discussed in detail in Chapter 1. Perhaps the most important difficulty is the enormous problem that centralised decison makers face in collecting and processing information. It should also be recognised that intervention which is targeted at one group must be paid for by another. This may or may not be equitable, and may affect the efficient allocation of resources and incentives to work, save and invest.

In the past, fiscal policy has often been used in an attempt to manage aggregate real demand. While it is clear that fiscal intervention can influence economic activity in the short term, it is doubtful whether demand management has any long term beneficial effects. The impact of fiscal policy on economic activity in the short term is difficult to predict, and as the 1984 Post-Election Briefing indicated, New Zealand's practical experience has not been positive. We do not believe that in normal circumstances it is desirable to make fiscal decisions with a view to managing real demand.

Poorly conducted and changeable fiscal policy introduces unhelpful uncertainty into the economic environment; deficits lead to rising debt and debt servicing burdens; high levels of expenditure impose heavy tax burdens on the economy; poorly targeted expenditure wastes resources; and chronic imbalances between revenue and expenditure may destabilise financial markets. In view of the capacity for misdirected fiscal interventions to have adverse long-term effects, it is important that decisions affecting individual government expenditures be made on the basis of careful considerations of the implications for equity and economic efficiency. Taxation decisions should be aimed at ensuring that the Government has a sound and sustainable financial position.

Fiscal Outlook

The previous section noted that expenditure had risen steadily over the past 15 years. It is projected to remain at a high level due largely to growth in debt servicing costs and an increase in social security transfers. Associated with rhis increase has been a strong growth in tax burdens. Total taxation has risen steadily over the same period, with growth in personal income tax being particularly strong until the recent tax reforms. The deficit deteriorated markedly until 1983/84 and since then has shown an improvement. Despite the improved deficit position, a succession of past deficits has resulted in the buildup of a substantial stock of debt. New Zealand now has one of the higher debt to GDP ratios in the OECD.

A new expenditure planning round will be undertaken shortly. At this stage our preliminary assessment would suggest that, on present policies, expenditure and tax levels will remain around their current levels in relation to GDP. On this basis the financial deficit is projected to remain around 2 percent of GDP. The main risks associated with these projections centre around upward pressures on expenditure and a high degree of uncertainty that surrounds tax forecasts.

This section of this chapter discusses the principles that should be used in analysing expenditure, revenue, fiscal deficits and indebtedness.

Expenditure

The critical criteria that should be used for analysing government expenditure are microeconomic ones. The quality of government expenditure is the key concern. Individual government expenditure programmes should be examined to determine whether they are achieving society's objectives for efficiency and equity. If not, or if alternative institutional arrangements would deliver desired outcomes more efficiently, then fiscal intervention is not appropriate.

Government activities should be carried out only where the benefits exceed their full economic costs. Where the objectives can be achieved using commercial processes, then that option should be selected. A market test provides an objective indication of the extent to which the activity is valued by its beneficiaries, and the scope for measuring performance in financial terms will improve the incentives and accountability of managers. Where the goods or services might be provided more efficiently by the private sector, the Government should review its involvement in that area. In the case of non-commercial activities, where the benefits are difficult to measure, it is particularly important that the adminisrrative and financing costs (including dead weight losses of adding to the tax burden, current and future) be taken into consideration when this evaluation is made. Financial support, mainly in the form of transfer payments or subsidies, provided on social grounds should be delivered in a transparent way in order to reduce the likelihood that its cost will be underestimated.

The Government should assess capital expenditure by evaluating the return on the investment and satisfying itself that this will be adequate. This is true regardless of whether the benefits can be evaluated in commercial terms or whether the benefits must be assessed judgementally because, as with roads no market exists. Where assets produce a better return in the private sector than the public sector, they will be more valuable if they are sold than if they are retained in government control. Selling them would increase productivity and growth in the economy and generate additional tax revenues without increasing average tax rates. Although this would imply sacrificing any future revenues which the assets would earn, the proceeds from such sales would allow the Government to reduce its borrowing or retire debt, thereby reducing the debt servicing burden. Since rhe price at which the assets are sold should reflect the higher. value they will have under private control rather than their existing value, the transaction would increase the net worth of the public sector and reduce the future tax burden.

There are many areas in which expenditures have been inefficient or have failed to meet desired objectives. For instance, the Project Employment Programme merely served to displace private employment generation. Similarly, National Superannuation and the Family Benefit involve large amounts of unnecessary expenditure in order to provide assistance to those genuinely in need. These are not the only examples of poor fiscal interventions.

The history in New Zealand of fiscal policy which has failed to meet rhe criteria of improving efficiency or equity, or of being the most efficient way of achieving objectives, suggests that the institutional arrangements in place for ensuring quality decision making and efficient implementation of policies need to be carefully examined. Chapter 2 discusses in detail some of the current inadequacies in the institutional framework and suggests reforms that could be implemented. The chapter notes, for example, that the current expenditure system encourages managers and departments to compete for increased cash allocations each year rather than providing incentives for them to use their current resources efficiently. Institutional improvements which would impose more powerful incentives on managers to perform ate outlined there. In particular, improved accountability, effective performance assessment and associated reward and sanctions are likely to provide better incentives. This would allow departments then to reap the benefits of good management and face sanctions for poor performances.

Financing Expenditure

The most efficient method of financing expenditure will depend to a large extent on the type of expenditure which is undertaken. Where the beneficiaries can be identified and goods and services can be provided in a commercial manner, the full costs should be covered by charging policies. This concept underlies the policy of ‘user pays’ and the State Owned Enterprise programme. Where current expenditure is provided on equity grounds or where the beneficiaries are difficult to identify, financing of expenditure by taxation is more likely to be appropriate. Since most government expenditures are of this nature, the most significant form of financing is therefore likely to be taxation.

Given efficient financial markets that allocate funds to investments that are expected to pay high yields there would appear to be little need for the Government to undertake, or to provide funds to finance private capital investments for commercial activities. Private sector players are likely to have better incentives to carefully monitor any investment proposal they fund, and the quality of the investment decisions is likely to be better if left to them. However, where the Government does undertake such funding, and does so on the basis of commercial criteria, there is no reason not to finance this by borrowing. This should not involve further financing needs, since the investment returns can be expected to cover the costs of the borrowing.

Even where capital expenditure is non-commercial it is sensible to finance the expenditure by borrowing. This allows the costs of asset usage to be spread over the life of the asset in line with the benefits. By charging departments undertaking such expenditures for depreciation and interest costs, and financing these out of taxation like other current expenditures which cannot be recovered from user charges, enough current revenues will be raised to cover interest and full principal repayment during the life of the asset. The net effect for the Government is that only net additions to the stock of assets is funded from borrowing. A move in this direction, which would enhance the accountability of managers in the public sector by providing better information about their true use of the resources at their disposal, would require broad changes in the way departments are funded (see Chapter 2 for more discussion).

Deficits

Those government expenditures not funded from user charges or other non-tax revenues must be funded out of either current taxation or borrowing. Borrowing merely defers the taxation into the future. The question of the appropriate balance between current taxation and borrowing is complex. In addition to the measurement issues which are discussed in the Annexes to the 1986 and 1987 Budgets, there are two sets of factors that are important in determining an appropriate medium term fiscal deficit strategy:

i intergenerational equity;

ii contribution to balanced economic performance. Three issues ate discussed:

- — sustainability of accumulated debt;
- — role of fiscal policy in the disinflation process;
- — other risks associated with the fiscal position.

Intergenerational Equity

Fiscal policy raises issues of intergenerational equity because future generations will be affected by the assets and stock of debt they inherit, as well as any contingent liabilities, such as a commitment to fund superannuation schemes. Fiscal deficits, by affecting future tax burdens, therefore have intergenerational effects. There is no simple way of determining what constitutes a 'fair' balance between paying taxes in the present and deferring them to the future by borrowing. This judgement will depend on a multitude of factors such as the weighr currently attached to the welfare of future generations; populationgrowth, which determines the effective per capita burden of deferred taxation; and real interesr rates, which determine the cost of deferring taxation. Whether a governmenr is prepared to accumulate debt is at least partly a matter of political choice. However, there are a number of undesirable economic consequences that will arise if markets consider that projected debt levels are unsustainable. These are discussed in the next section.

Contribution to Balanced Economic Performance

Sustainability of Debt Accumulation

A fiscal deficit can be regarded as unsustainable if, with a continuation of existing policies, the ratio of net debt to GDP is projected to increasing without limit. An excessive accumulation of debt has a number of undesirable consequences. The most important of these effects are:

i rapid debt servicing growth will result in continued growth in government expenditure. If the deficit is not to increase, leading to even faster debt accumulation, other expenditures will have to be reduced or taxes will have to be increased;

ii interest rates may rise. The market may believe that with very large and increasing debt to GDP ratios, governments may be tempted to erode the real value of outstanding debt by letting inflation increase. Concerns about future inflation would be reflected in higher interest rates. In addition, to induce the private sector to increase the proportion of government securities in its portfolio, governments may need to pay an interest premium over and above that required -at lower debt levels. Continued large fiscal deficits which are financed in a non-inflationary way will tend to increase real interest rates and place upward pressure on the real exchange rate. This creates difficulties for those sectors of the economy whose businesses are most sensitive to financial conditions which include those exposed to international competition. Where much of the official debt is held externally, further large increases in the Government's debt sales programme may affect a country's credit rating and increase the cost of external borrowing in offshore markets;

iii if the sustainability of the fiscal position comes into question, a break in confidence in the economy may occur. Thus financial markets may mark the currency down sharply if it appears that the size of the domestic debt has reached a point where its reduction by inflation is the most likely outcome. In the New Zealand context, with a large stock of external debt, a fall in the exchange rate would increase the cost of servicing foreign currency debt, thereby worsening the fiscal position increasing the likelihood of an inflationary outcome.

Although New Zealand's net official debt to GNP ratio is not the highest among industrial countries, and is well below the historical peaks that have been experienced in some, nonetheless, the official net debt ratio has increased rapidly over the past decade. There is no simple and satisfactory way of assessing whether a given deficit is sustainable relative to the stock of debt. One technique sometimes used is to calculate whether present policies, if extrapolated, will cause the deficit to increase without limit as a share of GDP. The Planning Council's work suggests that, on certain assumptions about real growth and interest rates, the *surplus* before net interest payments would need to be around 0.5 percent of GDP. Treasury estimates suggest that from 1978-79 to 1984–85 there was a *deficit* before interest of over 2.5 percent of GDP. More recently the situation has improved: in 1985-86 and 1986-87 the *surplus* before interest was around 1 percent of GDP and is forecast to increase to around 3 percent of GDP in 1987/88.

Contribution to Disinflation Process

As discussed in the disinflation chapter, a consolidation of the fiscal position would assist in spreading the burden of disinflation more evenly across sectors. To date, those sectors whose fortunes are tied most closely to interest rate and exchange rate developments (such as exporters) have faced the greatest adjustment pressure. A reduction in the fiscal deficit, would put pressure on the relatively sheltered parts of the economy such as the public sector-particularly if achieved by reducing expenditures on goods and services-spreading the burden away from the exposed sectors.

There is also a case for continued reductions in the fiscal deficit to produce better balanced support for the disinflation progress. Action to reduce the financial deficit, and particularly the growth in expenditure, would help to strengthen confidence about future economic prospects and act to reduce inflationary expectations thereby contributing to a more stable economic environment. It can be argued that as long as disinflation remains a policy objective there is a case for maintaining a fiscal policy stance that acts as a moderating influence on the growth of nominal demand within the economy.

Risk Factors

In the absence of any discretionary policy changes, ongoing financial deficits of around 2 percent of GDP seem likely for the next few years. However there are a number of risks associated with this outlook. The discussion of the stock of debt, above, noted that with a large part of the public debt denominated in foreign currencies, a fall in the exchange rate could increase the cost of debt servicing and put pressure on the fiscal position. Another factor is that the deficit outlook is predicated on the assumption that the substantial increase in tax revenue forecast for 1987/88 is achieved and that this level is broadly maintained over subsequent years. While these tax forecasts represent the best estimate available, there is necessarily considerable uncertainty surrounding the outturn.

Deficit Targets

There are a variety of factors that need to be taken into account in assessing the desirable level of the deficit. In the medium term, the general rule suggested in the 1984 Post Election Briefing and in the annexes to the recent Budgets was that the Government should, over time, at least maintain its net worth and avoid increasing its debt unless it is also increasing its stock of assets.

Annex I of the 1987 Budget estimated that the Budget night financial deficit of $1.27 billion would, after adjustment for cyclical functions and the erosion of the outstanding public debt by inflation (the ‘inflation tax’), contribute to improving the public sector’s net worth by around $600 million. However as inflation falls, the inflation tax on the stock of the outstanding debt also falls, so a financial deficit at present levels will not continue to maintain net worth. Thus, a falling rate of inflation requires that the target deficit be reduced over time. Given that lower inflation is both desirable and projected over the next two years, further reductions in the financial deficit are warranted.

A second reason why further fiscal consolidation is desirable is that while disinflation remains a policy objective there is a need for fiscal policy to act as a moderating influence on the growth in nominal demand.

A third consideration relates to the stock of debt. While maintaining the Government’s net worth constant in real terms ensures that current decisions will not make future generations' debt burden worse than the present one, there is no presumption that the Government's net worth is at an appropriate level now. Without complete information about the Government's balance sheet, including contingent liabilities, it is impossible to assess the level of the Government's net worth. However, the fact that past borrowing has largely been undertaken to fund current consumption makes it likely that the level of debt is high relative to the value of the Government's assets. This consideration suggests that a deficit level that actually improves the Government's net worth, that is, reduces the level of debt relative to the level of assets, is desirable. This would reduce the burden of taxation in the future.

The final set of considerations relate to the assessment of the balance of risk on the fiscal outlook discussed above. Given the existing stock of debt, fiscal deficit strategy should err on the side of good housekeeping over the next few years.

Conclusion

Fiscal intervention can be used to improve the efficiency and equity of economic outcomes by carefully targeting expenditure decisions and ensuring that they are soundly financed. However, there are limits to what fiscal intervention can achieve and these must be taken into account. While there have been important gains in achieving better fiscal balance in recent years, further progress is desirable. It is also apparent that expenditures remain at a high level and heavy tax burdens are likely to be imposing serious costs on the economy. Firm control of expenditure and determined efforts to improve the quality of programmes will assist the improvement of economic performance by reducing real tax burdens and enabling resources to be utilised in higher return activities.

INDUSTRY ASSISTANCE

Industry assistance policies provide support for particular sectors of the economy. Examples of such policies include subsidies and tax concessions for particular industries, export support programmes, import licensing, import duties, and regulations to protect industries from competition. This section discusses the role of selective government action toward industry. It concludes that a continuing and accelerating programme to reduce discrimination between and within sectors should be one of the central features of economic policy over the next few years, to encourage effective investment and a more dynamic economy.

This section is in three parts. The first part considers the principles for industry assistance reform, the second examines experience to date in New Zealand, and the final part discusses policy options for the future.

Principles for Industry Assistance Reform

Industry assistance is a double-edged sword. The Government cannot provide assistance to one individual or group in the economy without at the same time imposing on other individuals and groups the costs of this assistance. In other words industry assistance policies must be, either explicitly or implicitly, selective. In making any decision to intervene selectively to support a particular industry, the Government must, as for any other intervention in the economy, consider whether it will in fact produce the best outcome. In the case of industry assistance measures, that assessment would have to include judgements about whether the Government had the best information on which to base judgements about the future of the industry concerned, and whether government officials faced sufficiently strong incentives to monitor, and if necessary alter the direction of, any industry that is being assisted.

Industry assistance policies aim to increase the profitability of specific industries. That will encourage people to invest in the industry concerned. The direct cost of assistance is measured by the increased input costs or taxation burden imposed on other industries. The indirect costs include the effects that the assistance has on the exchange rate. The exact nature and distribution of that cost will depend in part on the type of assistance provided. There are many ways in which governments may deliver assistance to industries:

Restrictions on Competition

i regulatory barriers to entry into an industry allow that industry to raise its prices and pass on those costs to the rest of the economy. The general question of optimal regulation is dealt with in another chapter of this report.

ii import quotas are a specific form of regulation which act to reduce the flow of imported goods. As the supply of imports is choked off by quotas, the prices people will be prepared to pay for those imports will rise. This has implications both for importing and for domestic manufacturers. Normally the difference between the cost of the imports and the price consumers are prepared to pay will be extra profit for the importer. If, however the quotas are tendered, that difference will be paid to the Government. Import quotas restrict the competition faced by domestic manufacturers. As a result the import competing industries they protect are made more profitable while costs for all other industries are increased. Because import quotas guarantee local manufacturers a share of the market, they allow the competitiveness of local producers to decline without that share being threatened.

iii tariffs act to increase the price of imported goods, and thus allow local producers of competing goods to increase their prices yet still compete successfully. Like import quotas, tariffs make the local production of goods more profitable, but they also increase costs for the rest of the economy (consumers and consuming industries must either buy more expensive locally produced goods, or pay the tariff). The main advantages of tariffs over import licensing is that they do not provide local producers with a guaranteed share of the market irrespective of their efficiency.

Government Expenditure

Direct subsidies or tax concessions provide support for specific industries, again at the expense of the rest of the community, who must either pay increased taxes to fund the subsidy (or shortfall in revenue) or face the consequences in terms of inflation or rising public debt. The main difference between direct subsidies and tax concessions is that the cost to the public of subsidies is more obvious, and they are rherefore subject to more scrutiny.

The direct costs set out above can largely be seen as transfers between groups in society. Their only impact on community living standards is in the cost of arranging the transfers. Industry assistance has its more significant impact on living standards through a range of *indirect* costs, which reduce the economy's productive potential, and therefore lead to lower living standards.

Assistance to industries may allow them to secure resources which less assisted areas of the economy could potentially make better use of. For example, assisted industries may be able to pay high prices for the inputs (such as land, labour or capital) which they use, and pass these costs on to consumers. However, exporters and other industries more exposed to international competition who use these same inputs will often be unable to recover the increased input costs by raising prices.

There are some additional costs peculiar to any form of assistance which provide support for exporters or local producers competing with imports (for example border protection, and subsidies to either exporters or local producers competing with imports). The indirect costs of such assistance fall disproportionately on that part of the economy which faces international competition because of its *exchange r-ate effect*. To the extent that it reduces the flow of imported goods into a country or increases exports, that assistance leads to an increase in the real exchange rate. This higher exchange rate favours activities which do nor face international competition. While it reduces the price of imported inputs to all activities in the economy, it also reduces the competitiveness of those industries that face international competition, whether in local or overseas markets. Sectors of the economy which are not exposed to foreign competition receive benefits from the higher exchange rate, but pay none of the costs.

An undesirable side effect of disinflationary policies is that they tend to lead to an increase in the real exchange rate while inflation is being reduced which makes those areas of the economy that are not subject to foreign competition more profitable and produces a bias against sectors that are exposed to foreign competition.

The combination of the exchange rate impact of continuing industry assistance, and the impact of monetary policy on exchange rates, can combine to produce serious problems for exporters during the disinflationary period. The key point about this is that the exchange rate impact of disinflationary policy is temporary while the impact from industry assistance is continuous.

Protection of industry behind either prohibitive trade barriers such as import licensing or regulatory barriers that prevent competition has dynamic consequences. By limiting the degree to which industry faces competition, such barriers reduce the pressures on industry to adapt to changing economic circumstances and to strive continually for improved performance. That reduces the incentive on domestic industry to develop new products and to perfect new production techniques which will enable it to gain or maintain an edge over its competitors. This effect is likely to be cumulative. The longer industry remains relatively sheltered from competitive pressures, the greater its inability to make the continuing adaptations and introduce the new products and techniques necessary to remain competitive. This implies there should be a continuing move away from assistance mechanisms which do not allow competitive pressures to exert their influence.

Equally, assistance measures that require discretionary decision making by government officials on a case by case basis have dynamic effects on the economy. That is because they encourage enterprise managers to spend their time and efforts securing the right decision from government, rather than directing the course of their business. The abolition of import licensing in most areas has removed one of the most significant areas of discretionary decision making, but some others remain- the most significant probably being tariff concessions.

Any form of industry assistance obviously increases the viability of the industry it is protecting or supporting. That does not necessarily mean that the support accrues entirely to the owners or employees in the industry concerned. Some of it may well end up being paid to the industry's suppliers. For example, it is likely that some of the assistance provided in the past to farmers in fact accrued to either the food processing or transport industries. Similarly, it is not correct that the costs of providing industry assistance are borne by the Government. In reality Government merely transfers the costs of that assistance to other groups in society.

Ultimately any industry assistance policy will mean that some producers will get the assistance and others will pay for it. Since there is a cost to organising the assistance programme, that in itself may lead to a marginal reduction in living standards. The more significant result of the fact that assistance has a disparate impact on different industries will be, however, that investment will be promoted in the industries that gain from the programme, and discouraged in industries that lose from it. Government action to promote investment in particular industries would be sensible if government had better information than those involved directly in the industries about their future viability, and if governments faced strong incentives to alter the assistance regime in the light of changes in that information. In our view, neither of those conditions holds. The most effective decisions about investment are likely to be made by those who have the best information about the enterprise, and those who are accountable for its performance. All of that suggests strongly that Government's role should be to provide a stable policy environment for investment, and not in general favour one industry over another. That implies that the industry assistance regime should be neutral between and within sectors.

Industry Assistance and Employment

It is sometimes argued that industry assistance policies are necessary to maintain or increase employment. The overall level of employment is influenced largely by the responsiveness of wages and labour to changes in demand and supply in the various markets for goods and services, which are in turn determined by the general state of the economy and its international competitiveness.

In fact, what industry assistance does at best, is 'protect' or insulate one industry's output and employment at the expense of another's. In other words assistance tends to shuffle jobs around the economy in a pattern which is less productive for the country overall.

Even within the protected areas of the economy, there is some doubt as to whether assistance promotes employment growth. In the OECD area, for example, employment in the 'highly protected' industries declined more rapidly in the 1970s than in manufacturing as a whole. Protection in this case was not sufficient to fully offset the adverse impact of changes in competitiveness and in patterns of demand, though some could argue that it may have slowed the rate of decline.

Industry Assistance in Other Countries

Domestic producers sometimes argue that they should receive assistance comparable to the levels and forms of assistance which their foreign competitors receive. They argue that their ability to compete with foreign producers depends to a large extent on the New Zealand Government matching the assistance policies which operate in other countries.

Domestically, New Zealand consumers will get cheaper goods, and New Zealand industry will get cheaper inputs as a result of subsidies from overseas taxpayers. Just as New Zealand's industry assistance policies transfer costs through the economy, the same pattern is seen overseas. Our trading partners cannot assist some of their domestic industries without imposing costs on other industries in their economies and making them less competitive. This will create opportunities for trade in those *other* goods.

The notion of international neutrality, has two logical deficiencies. Firstly, New Zealand cannot expect to achieve neutrality with *all* its trading partners. We can inevitably seek neutrality with only one at a time, but we would then lack neutrality with all other countries which have different regimes. Secondly, to be consistent, neutrality should extend to *all* the factors which determine a country's internal cost structure. These would include elements of economic policy (such as wages and prices) together with elements of social policy (for example education policy) the climate and resource base and social attitudes and ethics. The effect of such a policy would be to remove any of the potential gains from trade, which derive from the differences in relative prices between countries.

Industry Assistance and International Trade Negotiations

Unilateral moves to remove protection from New Zealand industry are sometimes criticised as undermining our position in the current GATT round of multilateral trade negotiations (MTN) by giving away our negotiating coin. It is claimed we will have less to offer other parties in return for the concessions that we request from them. This argument is ill-conceived because it assumes we can change assistance policies of the other countries . It also overlooks the benefits to New Zealand of making changes to our policy now. The view that trade barriers should only be removed grudgingly partly accounts for the overall lack of success of previous GATT rounds. In those rounds, countries measured their success by the ratio of what they gained over what they had to concede. If there is to be progress in the Uruguay round there must be a change of attitude: the recognition that there are major economic benefits from unilateral trade liberalisation. The present language of the GATT, which talks of offers and concessions, tends to obscure these benefits.

Industry Assistance—International Evidence

The adoption of an outward-looking growth strategy which is broadly neutral in its approach to different sectors is a fundamental element of the present economic reform programme. An outward-looking approach does not necessarily mean favouring production for export over production for the domestic market. Rather it involves ensuring that as wide as possible a cross section of the economy faces world price signals. This strategy involves ensuring the pattern of industry development in New Zealand is the best that can be achieved given the structure of world prices. International evidence has provided general support for that approach. A recent example is the 1987 World Development Report from the World Bank which includes a study of the trade policies of 4 1 developing countries over 22 years. The study investigates the link between particular types of trade policy and growth. It concludes that developing countries which have pursued an outward-looking economic strategy have fared better than those which insulated themselves from international competition. Among the group the main achievers have characteristically pursued policies that have not discriminated between production for the domestic market and production for the overseas market.

A Review of New Zealand Liberalisation to Date

Industry Assistance Policy in New Zealand

In the past industry assistance in New Zealand was essentially ‘needs based’. That is, it provided assistance selectively to those industries which the Government decided ‘needed’ assistance to be viable, and based the forms and levels of this assistance largely on what was perceived to be the extent of individual industries’ ‘needs’. As a result those industries which were least efficient in using resources received the greatest rates of assistance. The recent across the board moves to reform tariffs and import licensing indicate a clear step away from ‘needs based’ assistance, although the continuation of a range of special industry plans still reflects this concept. There are several problems with the concept of a ‘needs based’ assistance regime.

There are presumably few, if any, activities which New Zealand producers could not undertake profitably if they received adequate assistance. However, in the case of many goods the level of assistance required, and the costs imposed on other activities in the economy would both be substantial. In effect we‘ cannot provide assistance to those industries which ‘need’ it to be profitable without simultaneously penalising those, inherently more profitable industries, which can operate without assistance.

A ‘needs based’ assistance regime requires Government to make decisions about which industries require assistance and about the forms and levels of that assistance. In general the Government will not be as well informed about the potential viability of an industry as its owners, nor will it face the proper incentives to monitor the industry. Ultimately the result of a needs based tariff programme will be that local producers are encouraged to devote a great deal of their effort to seeking more assistance which directs management attention away from more effective operation of their enterprise.

The Adjustment Process So Far

The process of industry assistance reform in New Zealand to date has involved a number of actions:

- The widening of the free trade agreement with Australia (ANZCERTA).
- The progressive removal of import licensing and phase down of tariffs.
- The continuing phase out of a wide range of production subsidies.
- The phase out of export incentives.
- The phase out of concessional tax treatments.

The ANZCERTA agreement was signed in March 1983. Under that agreement, all trade between Australia and New Zealand will become free of both duties and quotas by 1995.

For 70 percent of the manufacturing sector, import licensing is scheduled to end on 1 July 1988, and tariffs above 25 percent were reduced by 5 percent of the tariff on 1 July 1986 and then by 10 percent of the tariff on 1 July 1987. In a number of industries, covering around 30 percent of total industrial production, there are specific plans for gradual reduction of tariffs, and in many but not all cases these plans provide for the removal of import quotas. The pace and timing of the continuing tariff reform programme is under review at present.

While much of the wide range of assistance measures previously available to agriculture has been abolished or phased out, a substantial amount remains. The changes to date have included the abolition of Supplementary Minimum Prices (SMPs), the move to market rates of interest for both Rural Bank and producer board finance, the repeal of a range of tax concessions, and the introduction of 'user pays' for a range of services. For non-traditional exporters, the Export Performance Taxation Incentive (EPTI) phased out this year,- and the Export Market Development Taxation Incentive (EMDTI) will phase out in 1770. The parallel schemes of assistance to the tourist industry are being phased out on the same timetable. One of the factors in the phase out of export incentives was pressure from trading partners, both through GATT and the ANZCERTA. The Government has arranged a temporary system of grants to exporters and the tourist industry.

Inevitably the changes to assistance programmes have had differing impacts on the three sectors of the economy involved. Non-traditional exporters and the tourist industry have had most of their assistance removed, and by 1770 it will have virtually disappeared. At the same time they will continue to face the costs imposed by assistance to other sectors. Assistance to pastoral agriculture reached a peak in 1983/84. Since then assistance to agriculture has been reduced a great deal. Two factors need to be noted. Firstly, the future path of assistance reductions for agriculture appears likely to be quite rapid. Secondly, a good deal of the assistance available to pastoral agriculture (Rural Bank interest subsidies) is not available for new investment in the industry, and therefore is unlikely to lead to perverse resource use.

There are major disparities between the levels and rates of change of assistance to different activities in each of these sectors. In pastoral agriculture, the highest levels of assistance in the past were made available for sheep meat production. Over the last few years that assistance has been substantially reduced. Within the manufacturing sector, levels of effective assistance vary widely. For some industries in fact, the extra costs they pay as a result of assistance to their suppliers are far greater than the assistance they receive themselves. At the other end of the spectrum there are industries which receive more in assistance than their production is actually worth. While assistance to most manufacturing industries has been reduced, some of the most highly assisted industries have been somewhat sheltered from the impact of the liberalisation programme.

In general the pressure of adjusting to a new assistance regime has been felt most by non-traditional exporters (who have generally faced the most rapid reduction) and least by manufacturers producing for the local market.

For all sectors of the economy, much of the economic difficulty over recent years has come from exchange rates and interest rates (which are linked to stabilisation policy). In the case of the farm sector world commodity prices and the reduction of farm assistance have caused some difficulties. For manufacturers, it is high exchange and interest rates, rather than the reduction of assistance that are generally seen to be the major difficulties. Indeed most manufacturers accept that they have to date coped well with adjustment to the new assistance regime.

Some publicity has been given to the fact that some New Zealand manufacturers are moving their production offshore. Two points should be made about this process. First of all it is quite sensible to move some production offshore. Part of the reason for a programme of reform of industry assistance is that some of the goods we have produced in New Zealand could be far more efficiently produced elsewhere. Secondly, some decline in manufacturing as a proportion of the total economy has been seen over recent years in other developed countries, along with a growth in the service sector of the economy. That does not necessarily mean it will also happen here, but it does suggest that policy should not treat a constant size manufacturing sector as a goal.

Regional Impacts of the Assistance Programme

A good deal of attention has recently been given to the relative performances of the provincial and urban economies, and the role of government policy in these differences. Industry assistance policy offers some insights into this process.

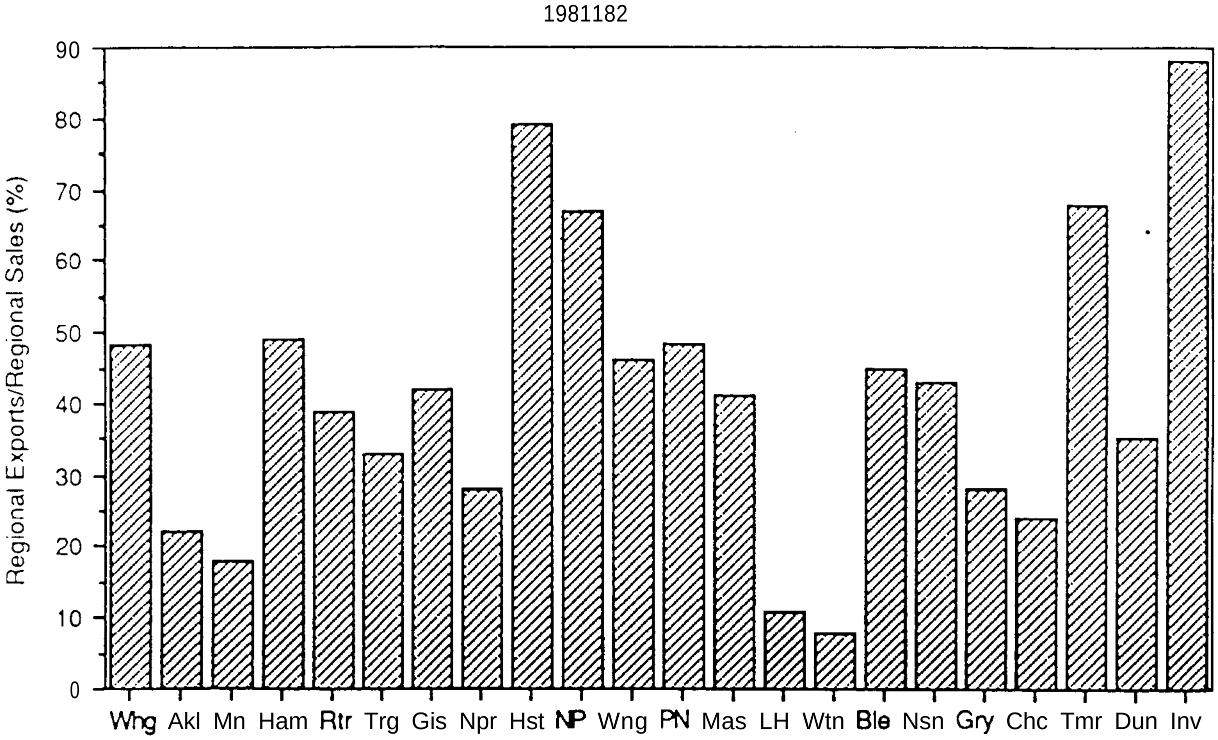
The manufacturing industries which produce goods for local consumption, tend to locate more heavily in the urban centres to take advantage of lower distribution costs. Export industries on the other hand, tend to locate close to their natural resource base which is often in provincial areas. Industries producing for export generally receive less assistance than those producing for the domestic market. This is both because the levels of assistance made available through export incentives were generally less than those available through tariffs and import licensing, and because exporr incentives have been phased out more quickly than tariffs and import licensing.

One of the implications of differential levels of assistance is that living standards and employment in regions with relatively high concentrations of protected industries tend to be promoted, at the expense of living standards and employment in other regions. This suggests that a more neutral assistance regime (that is, one which does not discriminate between sectors and between industries) could significantly benefit those regions with a low concentration of assisted industry.

Preliminary work on the concentration of protected industry in the manufacturing sector, including primary product processing, in New Zealand indicates that the industries with the highest effective rates of assistance are located in the main urban centres. The following two graphs show the average level of effective rates of assistance for industry, by region, and the proportion of production exported, by region.

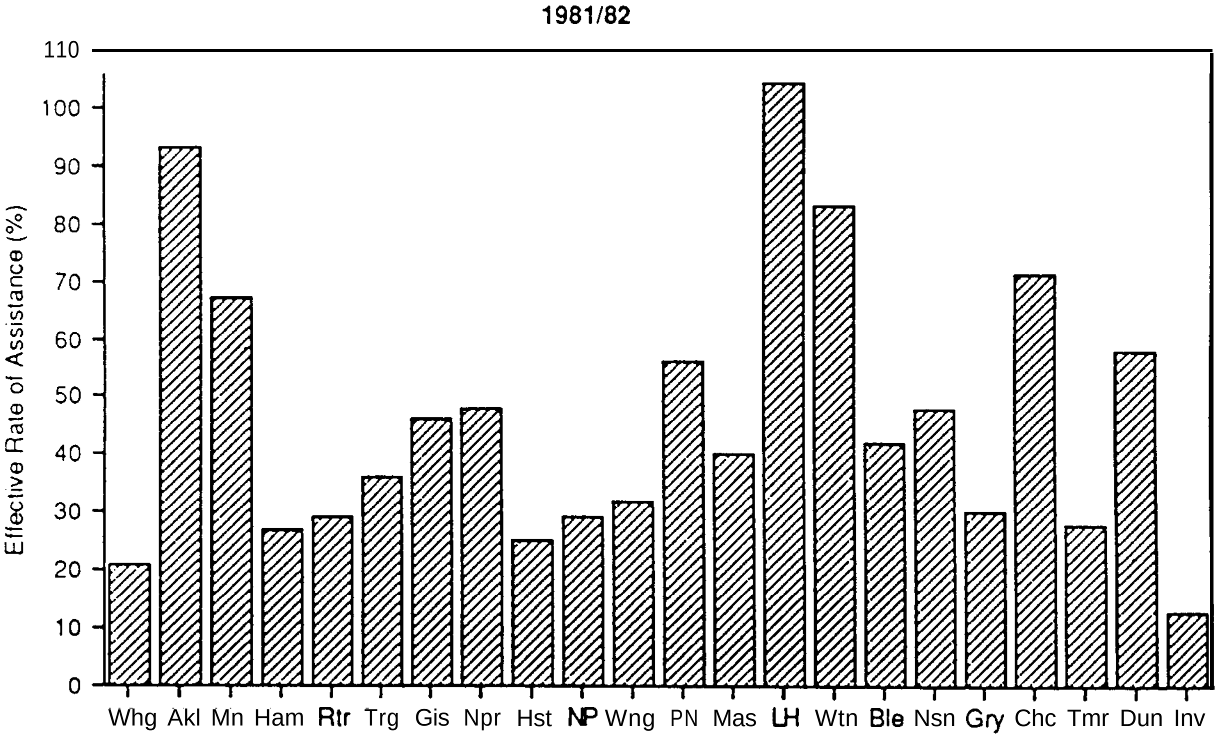
The data would tend to suggest that the regional economies are bearing a relatively high burden of the costs of the assistance given to manufacturing industries and that proportionally more of the assistance goes to the urban centres. The regions would be likely to gain from a reduction in average levels of assistance to manufacturing industry. The data also suggest that the regions

GRAPH 4.4: Exports by Region



Source: Treasury Estimates

GRAPH 4.5: Regional Assistance Patterns



Source: Treasury Estimates

would tend to gain from industry assistance reform which made exporting more viable.

Directions for Reform

Pace of Change and Policy Goals

Quite clearly the present system of industry assistance, which supports local manufacturers more than either agricultural or non-traditional exporters, and which provides widely varying levels of assistance within each of these sectors, requires continuing reform. If different industries are offered widely differenc levels of assistance by the Government, that will tend to promote investment in those industries that receive the highest levels of assistance, at the expense of investment in other sectors. A more even-handed policy will result in a more effective pattern of investment throughout the economy, leading to stronger economic growth and higher living standards. Faster progress towards those policy goals will bring those higher living standards more quickly.

There is also a danger that an excessively slow path for adjustment will lose credibility. It could simply encourage those who must change their production patterns to defer that change, and to lobby instead for the programme to be abandoned.

There are, however, potential problems with an excessively rapid programme for reduction of assistance. A very rapid adjustment period, if it lacked credibility, could encourage producers to lobby for the programme to be abandoned, rather than actually to adapt to it. Beyond that, some of the labour and capital employed in the industries might have specific attributes which reduce suitability elsewhere. A period of notice would, however, allow people to search and if necessary to retrain for a new job. In short a reasonable period of adjustment will minimise the extent to which people are unemployed and production falls as a short-term response to the new assistance regime. It should be noted, however, that there is a tendency for the community to overestimate the difficulties being posed by an assistance reform programme. The pressures created by the ANZCERTA process, the phase out of import licensing, and the phase down of tariffs have generally been significantly less than was feared at the time the processes began.

A separate section of this chapter considers, among other issues, the general question of the pace of change which government policy can reasonably impose on the economy. It expands on the preceding points.

The ideal pace of change for industry assistance policy is a matter for judgement, but on the basis of experience to date we conclude that the reform programme for assistance to import substituting industries in particular could be significantly accelerated without imposing excessive adjustment costs on the economy, and that accelerating that programme would bring significant benefits.

It is important to consider the nature of the conflict between rapid and significant change and another feature of progressive adjustment, namely that there be consistency in the rules of the game. Prominence is often placed on the point that particular government interventions provide security for investors. By the same token, however, the introduction of a new question-how long the intervention might last-can provide a substantial source of risk.

Governments cannot provide absolute certainty and guarantees for the future. The best they can hope to do is provide a clear policy direction for business planning. Absolute stability is not only unattainable but is also undesirable. Such relative macroeconomic stability as it may be possible to achieve, depends on the ability of individual units within an economy to adjust in the face of constant change. Thus continuing adjustment, occurring spontaneously and speedily, is an essential condition of economic stability.

Much of the gain from industry assistance reform comes from the dynamic impact on industry. In our view dynamic gains have come from two main areas:

- i from exposing sheltered areas of the economy to some form of price competition—and that suggests that there are big gains from removing import licensing and other restrictions on competition;
- ii from encouraging management resources to concentrate on the efficient operation of the enterprise rather than attempting to alter government policies. This suggests a need to remove wherever possible the discretionary element of the industry assistance regime.

The returns to such lobbying depend simply on the credibility of the reform programme -that is to say on the extent to which producers believe that lobbying will actually produce results. A programme which is consistenr and inevitable will discourage lobbying. A programme which appears susceptible to modification will not. All of this suggests that policy decisions on industry assistance should be consistent both with each other and with the broad policy framework. It also suggests that the goal of policy should be a system that avoids where possible discretionary decision making powers, discouraging people from expecting special treatment from the Government.

Options for Reform

The central characteristic of assistance is that it is a relative concept. When a specific assistance policy is established, relative prices are altered to give the chosen industry a preferred position in comparison to other acrivities. Assistance concentrated in a few isolated areas will encourage the retention of investment and growth in these highly assisted areas-at the expense of the rest of the economy.

Excluding activities from the economy-wide programme to reduce assistance or even shielding them from its most significant impacts is likely to generate a slower rate of adjustment than would occur under an all-embracing reform of assistance. One major result of exempting activities from the general programme is a rearrangement of adjustment pressures. Special treatment constrains the stream of benefits expected from the development of the more competitive activities, as well as preventing a larger contraction (or smaller expansion) of some industries which would otherwise have been unable to compete for resources.

Currenrly in New Zealand 30 percent of manufactured goods output (by domestic price) is covered by industry development plans. Among these are some of the most highly assisted industries, including motor vehicles, apparel and footwear. The Footwear Industry Development Plan was reviewed in 1786 and will be considered again in 1770. The Motor Vehicle Industry Development Plan is under review now. The industry plan for apparel is due to be re-examined in early 1788. In none of these three areas—motor vehicles, apparel and footwear—has the Government yet undertaken to remove import licensing.

Import licensing has a number of drawbacks. It provides local industry with more insulation from world prices than the tariff does. Therefore we see rhe removal of imporr licensing across all industries as a priority. The licence tender premiums which are currently high in a few industries are a reflection of the high levels of assistance provided through licensing. They reflect the costs of such assistance to the community,and are themselves an argument for abolishing the last vestiges of import licensing.

Beyond that, the most important field for the reform of industry assistance is the tariff. There are a number of choices to be made about the tariff reform programme. The first, is between piecemeal or predetermined methods:

The *piecemeal* technique involves the investigation and adjustment of rhe protection provided to individual industries as part of a programme through time. The Industry plans, which provide for regular reviews of each industry, are examples of this approach. Piecemeal reviews of protection have a number of drawbacks. This approach tends to enable industry specific issues to dominate examinations, to the disadvantage of more general economy-wide concerns. The difficulties under this method in securing agreement to tariff reductions for the highly assisted industriss have been a major obstacle. It tends to produce a 'needs based' tariff. Furthermore, the results of specific industry studies tend to be strongly influenced by the existing state of the economy. This case by case approach can also lead to major disparities in effective rates of protection, and is a slow resource-intensive process both for officials and industry.

A *predetermined* approach under which the timing, speed and esrent of reductions are clear for all industries is much more likely to achieve uniformity; to begin working faster to reduce the average level of protection; and to lead to a simpler and more stable assistance structure. It also removes much of the discretionary decision making power, and is therefore an incentive to businesses to spend time improving their operations, rather than seeking specific decisions from the Government.

This argument points to the need to move away from specific industry plans which allow for discretionary changes to assistance, to an economy-n-ide assistance policy as soon as possible.

Secondly, a balance needs to be settled between a programme that reduces all assistance, and one that concentrates on reducing the highest levels of assistance. There are a number of specific ways of achieving the latter goal. The advantage of reducing the highest levels of assistance first is that some of the very large disparities between assistance levels to different industries will be reduced. The advantage of reducing all levels of assistance is that all industries must begin to adjust to lower assistance levels. Our judgement is that the ideal reform programme would reduce all assistance levels, but would reduce the highest levels of assistance by a larger amount.

The Reform Programme

This chapter has canvassed the issues surrounding industry assistance policy. Our conclusions are as follows:

i the ultimate goal should be an industry assistance policy rhat is neutral between sectors, and between industries within sectors;

ii the reform programme should expose industry to the full extent of changes in world prices, and should not encourage producers to believe it will be altered for special cases. This should ensure that the potential dynamic gains to the economy from assistance reform are achieved;

iii the disparate rates of change in the assistance regime and concern about maintaining the credibility of the reform programme, combine to suggest a significant acceleration of the present programme for reform of assistance to the import substitution sector. In that sector removal of the remainder of import licensing, and an accelerated tariff reform programme should be the priorities;

iv present assistance policies tend to increase the real exchange rate. The effect of the disinflationary programme, which tends to raise the real exchange rate, and the fact that exporters are often unable to pass on to their customers the costs imposed on them by assistance, can be ameliorated by a reduction in import protection since that will lead to some reduction in the real exchange rate. This effect would prevent undue penalties on the export sector;

v because export industry is concentrated in the regions, while highly assisted manufacturing industry is concentrated in the main centres, a continuing programme of assistance reform is likely to be of some benefit to the regions.

REGULATION

Introduction

The regulation of economic activity consists of Acts of Parliament and subsidiary legislative instruments which lay down constraints within which economic activity can take place. Some examples under the heading of regulation include: restrictions on competition in certain industries; controls on the emission of pollutants; requirements for disclosure of financial information; competition policy (the Commerce Act); health and safety requirements; company law; consumer protection legislation; tenants' protection legislation; and import quotas.

Other forms of government intervention such as taxes, subsidies and government ownership, are discussed elsewhere in the briefing. This section discusses principles for the design of effective regulations and provides a review of directions for future regulatory reform.

Chapter 1 of the brief discussed the general role that regulation can perform by providing an overall framework in which transactions can take place. For example the fair and efficient working of a market economy requires a body of law which among other things protects property rights, enforces contracts and prohibits fraud. Specific regulations can fulfil necessary and desirable roles. The basic structure of company law greatly reduces the contracting costs which would otherwise be involved in co-operative endeavour, for example in the event of bankruptcy. Similarly an effective patent law greatly increases the incentives to undertake private research and development. As a result there is a useful role for patent law to promote innovations even though it reduces the speed of dissemination of known information. Standard weights and measures are another example of regulation which promotes efficient markets by reducing the information costs of transactions. On the other hand inappropriate regulation can have adverse effects on economic efficiency. One study attributed around 20 percent of the slowdown in US productivity growth to the impact of regulations.

Around the world, evidence such as this has lead to widespread calls for deregulation. This perspective, however, risks a polarisation of views -and diverts attention from the real issue of selecting the best form of intervention. As Chapter 1 indicates, voluntary (market) transactions depend on the framework of rights which are enforced by the state. Thus regulation of some sort is integral to the operation of markets. The term regulatory reform better describes the process of searching for and selecting a set of regulatory interventions which will result in better outcomes for society. This may involve removing some specific regulations, but may also involve changing the form of regulation, adding new ones, or replacing regulations with taxes or subsidies.

An assessment of the overall impact of regulation is difficult. Some analysts have attempted to do so by counting the number of laws and statutory regulations governing economic activity. For instance, in 1985 the New Zealand Planning Council published 'The Regulated Economy' in which it estimated that, at that time, there were 400 acts of parliament and 1000 statutory regulations in force. It is information such as this that has given rise to a perception among many people that New Zealand is an over-regulated society.

Such information, however, says nothing about the economic effects of the regulations; how beneficial or harmful they might be compared to the alternatives. In assessing the costs and benefits of particular regulatory interventions it is important to consider nor only the direct costs and benefits but also their indirect and wider effects for instance on compliance costs, and the incentives to invest, to innovare and bear risks. An approach toward assessing these costs and benefits is outlined below.

In the following we first identify a useful approach toward assessing the costs and benefits of regulatory interventions; second review in general terms problems with the regulatory review process and suggestions for improvements; third identify progress that has been made in the last few years in regulatory reform and further identify priorities for further reform; fourth present some conclusion and finally apply the analysis we develop in the text to occupational regulation for purposes of illustration.

Principles for Regulatory Review

In order to evaluate a specific regulation it is necessary to address both whether the existing specific regulation is better than relying either on the framework of common law and general statutes, or some other intervention. In adopting such an approach the following issues should be considered:

i What would be the outcome of relying on voluntary transactions and the general legal framework, and how does this compare with the outcome under the regulation?

In order to evaluate current or proposed regulations some basis of comparison is required. In the past much of the analysis of issues for which regulations were proposed has been faulty. It has examined economic behaviour against a highly stylised norm of 'perfect competition' which completely abstracts from much of the realities of the world. More recently a comparative systems approach has been adopted. This approach takes greater account of the effects of uncertainty, information costs, opportunism and specific assets upon contracting costs and the difficulties they create for economic agents. In such situations market participants will nevertheless seek to overcome the costs and problems that arise. A comparative systems approach has two main implications for the assessment of voluntary arrangements. First voluntary arrangements within a general legal framework are not easily understood or explained through the use of simple economic models. Thus more care and skill will be needed in the analysis of market responses to the problems contracting parties face. Second the features of the world that raise difficulties for market transactions will hold at least as strongly under alternative frameworks of rights. In essence two imperfect alternatives exist.

ii What are the problems that arise and what are their sources?

Interventions are generally undertaken because of a concern about some outcome. A starting point in assessing regulations is to clarify what is the underlying problem. It may result from a particular specification of property rights. For instance the problem of depletion in the inshore fishery arose because the rights to the resource had not been allocated and hence fishermen individually had poor incentives to conserve the fish stocks.

Focus on the symptoms of a problem, rather than on the underlying causes can result in regulations having perverse effects. For example, the interest rate controls in 1983–84 were intended to benefit low income borrowers. Because the controls also held down the return to the lenders, there was a tendency to allocate scarce funds to borrowers with good savings records and repayment capacity. As a result the beneficiaries of the regulations in fact tended to be high income borrowers.

iii What other interventions are possible to overcome this problem?

Given that some of the results under voluntary transactions are regarded as undesirable either on equity or efficiency grounds, alternative interventions need to be considered to remedy those problems. Market realities as outlined above will raise difficulties for any alternative set of interventions that might be contemplated. At this stage, however, the task is to identify possible options. In Chapter 1 it was suggested that regulation should be restricted to alternative definitions of the right to use a resource but that regulations generally should not be used to restrict rights to enter into particular voluntary agreements. Given the constraints established by a set of rights, voluntary transactions will tend to result in actions that efficiently take account of all the costs and benefits involved. Therefore a suitable focus for regulatory changes to overcome problems and to increase the efficiency of resource use could be to examine legislative changes to rights that enable agreements among market participants to be reached at a lower overall cost.

In cases of information problems regulations on the use of information may be most appropriate. For instance, requirements to disclose relevant information may be more appropriate than contracting prohibitions or production and design standards. Disclosure allows buyers to make informed choices regarding safety or quality/cost trade-offs.

iv What overall effects does each intervention have?

The effects of each intervention need to be evaluated against the criteria that will guide the choice (for example efficiency, equity and liberty). It is critical that this evaluation take into account the features of behaviour actually encountered. A failure to do so may result in an invalid assessment of the impacts of activities. Consider an example such as resale price maintenance which is prohibited under the Commerce Act. Rather than it being a form of anti-competitive behaviour, in an open market, not protected by import licensing or prohibitive tariffs, resale price maintenance may really be an efficient way for a firm to handle problems with its agents.

A wide view should be taken of potential effects on behaviour outside the area directly regulated. For instance, the operations of the ACC might reduce the incentives for individuals to take precautions to reduce their need for health care. 'Free' hospital treatment may reduce the interest in diet and exercise required to maintain health.

Dynamic effects, also, may be important. One of the major costs of import protection arises from the diversion of management time toward political activity and away from innovation both in new products and in modes of operation. Overseas experience in the telecommunications industry has shown that opening the industry to competition has led to a faster rate of adoption of new technology with improved efficiency and greater choice for customers. Similarly while airline regulators are charged with maintaining efficient air services, it is unrealistic to expect them to be aware of the broader efficiency gains that could be achieved by restructuring air routes using the hub and spoke pattern.

This analysis of an existing or proposed regulation against the outcome under alternative regulatory environments enables an assessment of a 'problem' and what set of interventions is most likely to improve the outcome. It is worth noting that the effects of many regulations are complex and their results not easily understood. As a consequence the potential for regulations to result in perverse unexpected outcomes is likely to be higher than for other types of interventions. The example of occupational licensing is discussed at the end of this section.

Regulatory Review Processes

The complexity of assessing the effect of regulations means that a case by case approach is needed for each regulation or set of regulations. Given the vast range of existing regulation and the extent to which it is adapted each year, attention must be paid not only to new regulations but also to a review of the existing set. Special attention needs to be given to the process of regulatory review in light of a number of biases that exist which would result in a predisposition toward the use of regulations when other interventions would be better.

A number of these biases arise from the way public sector policy advice is organised and run. These issues have been discussed in some detail in Chapter 2 which outlines principles for the reform of the public sector. Application of these principles will reduce the tendency toward inappropriate regulation. Some further actions may be desirable, and are discussed as follows.

One source of bias is that the benefits of regulation are often easily identifiable and concentrated on relatively few people, generally a group with common interests who have an established means of communicating their interests to politicians. The costs, on the other hand, are often diffused among many people, often the whole population, affecting most individuals only slightly. This means that it is easier to organise political pressure on behalf of regulation than against it.

A manifestation of this problem is the phenomenon known as 'regulatory capture'. Particular groups in the private sector seek government regulation, usually to restrict competition within their industry in order to further their own interests, and are supported in this action by the bureaucracy. Capture may be of either the advisory process, or of the administration of regulations once they are in force. Capture can also result from actions of the bureaucracy when members of the public service involved in the administration of regulation have a vested interest in its continuation and extension.

The government process itself tends to bias intervention toward the use of regulations rather than other policy instruments. Parliament has achieved a greater degree of scrutiny over expenditure and taxation than it has over regulatory powers. Whereas subsidies are explicitly appropriated and subject to annual review, regulatory agencies are not accountable for the costs imposed by regulations in the same way. There is no reduction in the agency's budget if an extra regulation is introduced which imposes extra costs on the private sector. Thus in the choice of policy instrument government agencies will rend to be biased against subsidies and in favour of commands.

A notable problem in the review of regulations is that the proponents of a particular new form of regulation often discount the difficulties that a regulatory solution to a particular problem will encounter. In other words, there is a recognition of 'market failure' but not of the pervasive phenomenon of 'government failure'. Government failure with respect to regulation tends to arise for three important reasons. The first is the difficulty and cost of obtaining the information relevant to the amount and type of regulation needed. The second is the difficulty of designing incentives in the public sector for individuals as agents of the public to pursue faithfully the interests of their principals. The third is the need for regulation to use legislative 'rules of thumb' which will turn out to be an inappropriate response in particular situations.

There is also a tendency among proponents of a particular regulation to discount private contractual arrangements or the common law as solutions to perceived problems. Proponents of the regulation of the professions, for example, often do not take into account the ability of a profession to regulate itself. Self regulation is less of concern where competition is allowed. The proponents of some sorts of consumer protection regulation likewise discount unduly the ability of consumers to obtain relief through insurance or through court action for damages.

All these causes of bias work in the direction of the introduction and retention of regulation or toward poorly designed interventions. A question which arises is whether some means can be found of counteracting these sources of bias.

Part of the problem of bias clearly lies with the structure of the public sector advisory process, with conflicting goals and an incentive structure which does not align the interests of all advisors with those of the Government. A number of changes are proposed in Chapter 2 which would improve the accountability, incentives, and monitoring of the public sector. If these changes were adopted advice would be less likely to favour particular interest groups at the expense of broader community interests.

Another approach would be to increase scrutiny so that any regulatory proposal is examined as rigorously as proposals to increase expenditure or taxes. A key element, therefore, would be to make apparent at the political level a commitment to regulatory reform. Alternatives could be either to charge particular policy departments with the responsibility of undertaking a major programme of review, or to charge all Ministers and their officials with the responsibility of reducing unnecessary regulation. One way of increasing the political commitment to the programme might be to give an undertaking that the recommendations of a review team would become law one year after being reported to Parliament unless legislation to the contrary had been introduced in the meantime. The operations of a special regulatory review agency such as the Economic Development Commission's Regulatory Reform Unit could be of value as part of such an approach but should not be seen as a substitute for retaining regulatory review as an integral part of the mainstream policy process.

One proposal sometimes raised, is to place a sunset clause on new or existing legislation. This proposal would have the advantage of ensuring that redundant regulation would be removed automatically. However for regulation which is in place to facilitate voluntary transactions, such as for weights and measures, it would be quite disruptive if a sunset clause were to be applied. A sunset clause could also generate considerable uncertainty each time the sunset period drew near. Thus, the most likely applications for these provisions would be in areas where the regulation is expected to be required for a finite time only.

To the extent that the bias exists because of a lack of widespread appreciation in the community of the true costs and benefits of the regulations, then wide dissemination of the results of analyses should be beneficial. Public release of consultative documents, reports of the Economic Development Commission and official information all have a role to contribute.

A further approach is to apply the principles identified before to a broad group of similar regulations. In comparison to earlier ad hoc approaches to regulation a process which begins by announcing principles that are to be applied to a related group of regulations may both minimise scope for capture and improve consistency and coherence of policy. This was largely the approach adopted in relation to reform of state owned enterprises.

Substantial regulatory reform initiatives of this sort can be expected to generate benefits that in the aggregate become apparent to the electorate more readily than would the benefits of a slower and more piecemeal approach to regulatory reform. For example, occupational licensing is an area where an across the board approach seems warranted.

A related approach is to harness the complementarities between different regulations. In the financial sector for example there were strong interactions between restrictions on entry for foreign exchange dealers, interest rate controls, controls on international capital flows and the exchange rate regime. Hence, financial reforms needed to be implemented as part of an overall package in order to have maximum benefit.

The next section briefly examines the progress that has been made in the last few years, and looks at the priorities for further consideration. This is followed by a concluding section. In the last section of the chapter we apply the analysis of the last two sections to a particular case of regulation-occupational regulation.

The Direction for Reform

Critical review of the impacts of so-called economic regulation in a number of areas have resulted in considerable regulatory reform in recent years. A feature of this process is that it has not resulted in widespread disruption. A review by the New Zealand Institute of Economic Research (NZIER) in 1985 of several product markets including bread, beer, road transport, cement, and financial services showed that regulatory reform generally resulted in lower prices, greater efficiency and improved quality and consumer choice.

However the review programme so far has been uneven and there are large areas of regulation which have not been exposed to critical scrutiny in recent times, particularly amongst so-called social regulation such as those health, safety and environmental regulations which generally deal with the side effects of economic activity.

The priorities for further reform should be determined by two principal considerations; the likely gains in economic efficiency or equity from that regulation alone, and the extent to which this policy interacts with and complements other policy changes being undertaken. The following discussion is not intended to be a list of priorities. Rather it is an attempt to place government intervention in the various areas of economic activity in some sort of perspective in terms of the principles discussed in the previous section.

Factor Markets

Labour Market   Next to the reform of industry assistance the reform of labour market regulation offers probably the most substantial efficiency gains of any reform measure. Labour market regulations can affect the adjustment costs to the community from both the disinflationary policies and from reform of import protection. As a result a separate section in this chapter is devoted to this subject.

A related area is the different regulations governing occupations where the worker must be licenced or registered. A number of aspects of many such regulations amount to restrictive trade practices, or enable members of these occupations to carry out restrictive trade practices. A review may be inevitable, in time, where these are in conflict with the Commerce Act, but in view of the impact on the economy of this part of the labour force a comprehensive review of all such professions and trades may be in order. As noted this section uses the case of occupational regulation to illustrate the application of principles for regulation reform identified earlier.

Capital Market   The major achievement to date has been the reform of capital market regulation. The removal of interest rate, reserve asset and exchange controls, the relaxation of some inward foreign investment controls, the floating of the exchange rate and the entry of new banks have all been important initiatives in creating the conditions whereby scarce debt and equity capital can be allocated to its most productive uses. There are some further initiatives in train which will reinforce the beneficial effect of these developments. These include the reform of regulations affecting building societies, trustee banks, and stockbrokers, the reform of the Trustee Act, and changes to the operation of the state owned financial institutions. Further efficiency gains can be expected from continuing improvements in the forms of capital market regulation.

Some areas still need attention, such as the the area of earthquake insurance; the taxation of superannuation and life insurance, the stock exchange and role of the Rural Bank and the Housing Corporation, neither of which operate in a competitively neutral environment. A review of the Securities Act is also desirable.

Market for Land The regulatory environment affecting land use has not been affected directly by any major initiatives to date. As a result, substantial efficiency and equity gains should be achievable in this area. The main regulations here are those affecting land aggregation and purchase, the Water and Soil Act and the Town and Country Planning Act. Although the latter two are currently under review, the area is a complex one and the analysis is at an early stage of development, so that it is likely that substantial results are some way off.

Product Markets

Goods for the Domestic Market The further reform of industry assistance in the import substitution sector is seen as an urgent priority. International experience shows clearly that to achieve high levels of economic growth small countries should have an economy characterised by relatively unbiased incentives and be open to international competition. The constituency for further change in this area is variable, but on the whole not unfavourable. It is important to eliminate import licensing in all areas and to move more rapidly towards lower and more uniform tariffs. This is discussed further in the section of this book dealing with industry assistance.

Regulatory reviews have been completed for a number of agricultural industries producing largely for the domestic market. Reforms in the wheat, egg and town milk industries are all expected to produce significant gains in efficiency.

Export Goods The agricultural sector was discussed in detail in the 1784 post-election briefing and indeed, much reform has since taken place. There have been a number of changes to the operation of producer boards, notably the removal of their access to concessional Reserve Bank finance. The legislation covering these changes was before the House when it rose. Further reviews of the boards' statutory basis should be undertaken which concentrate on areas where the boards have the power to levy or to coerce behaviour by industry participants.

Concern arises here just it does in the public sector about the mechanisms that drive these statutory agencies toward efficient and innovative practices. In particular the mode of ownership of statutory marketing authorities affects both their incentives to invest in profitable activities and also their ability to raise capital. With the liberalising of the capital market and the greater needs of the boards to rely on commercial sources of finance the financial structures of the boards may no longer be appropriate. In addition the export monopoly powers reduce pressures for performance and a greater degree of contestability is crucial.

Given the similarities between the organisation of the boards and that of government departments much of the discussion concerning government operating agencies in Chapter 2 will also tend to apply to producer boards and would be appropriate to consider during the review process.

It is likely that the role of the Horticultural Export Authority and the Market Development Board will need to be reviewed in the light of the principles developed for other statutory authorities.

Market for Services

In this sector, the major area of achievement remains the domestic transport industry, whose regulatory environment has improved substantially in recent years. Earlier initiatives also included the delicensing of the meat freezing industry, the delicensing of cinemas and the relaxation of regulations on shop trading hours. Some promising reforms are in train, principally in the areas of the review of the regulatory environment associated with commercialisation of state trading enterprises, the review of the Sale of Liquor Act and the review of building controls. However, little progress has been made in the reform of the operations of non-trading government departments and of the delivery of social services. Two recent policies which would appear to be less than optimal interventions are the introduction of the Residential Tenancy Act and the provision of conveyancing services by the Housing Corporation. A re-examination of these policies is warranted. A better solution to the cost of conveyancing would seem to be the introduction of open competition into a market which is at present reserved to solicitors.

In the services sector, major reforms are needed in the broadcasting, transport, energy, telecommunications, construction, distribution and social service sectors.

The need to liberalise entry into the radio frequency spectrum for television, radio and other services, and to move the BCNZ onto a competitively neutral footing are discussed in Treasury's submission to the Royal Commission on Broadcasting.

The external aviation policy has been revised so that negotiations with other countries for reciprocal landing rights and onward carrying rights is no longer primarily designed to protect Air New Zealand's market share. It is in the interests of both consumers and the tourist industry for a bilateral marker liberalisation policy to be adopted. Ports and taxi services are currently under review, a review of civil aviation regulation will commence shortly and the Railways Corporation is undergoing restructuring. A review is needed of the basis of operation for the Shipping Corporation, New Zealand Post, Tourist and Publicity and the Tourist Hotel Corporation.

In the energy sector a review is underway on the regulation of the electricity, gas and petroleum markets. The regulatory environment of the telecommunications market is currently under review. In the construction sector a review of building and planning controls is underway with a view to developing a performance-oriented standardised national building code. In the distribution industry the remaining restrictions on shop trading hours and the controls on wholesaling and retailing of liquor do not seem to be appropriate. Restrictions on the ownership of pharmacies appear to be inconsistent with the equity and efficiency concerns discussed earlier, as does the Gaming and Lotteries Act.

In the social services area, a review of the role of government in the very large and important markets for housing, educational and health services has the potential to produce significant nationwide welfare gains. Chapter 3 is devoted to these.

Multi-Market Regulation

Competition policy is regulated primarily by the Commerce Act, which came inro force on 1 May 1786. It has been proposed that the Act be reviewed in 1788. There are two key provisions to the Commerce Act, one relating to takeovers and the other to trade practices. Mergers and takeovers of companies above a certain size are subject to Commerce Commission clearance. Such clearance will nor be forthcoming if the merger or takeover is likely to lead to the new firm having a dominant position in the market, unless the Commission judges that the benefit to the public outweighs any detriment to the public. The Commission's approval is required for so-called restrictive trade practices which 'substantially lessen competition'. Certain trade practices such as the practice of resale price maintenance are prohibited outright.

The legislation is based around the use of competitive forces to provide firms with the stimulus to keep prices down and to improve management practices. However the approach is based on a very simple view of the way markets operate. When complexities such as contracting costs and information problems are taken into account then so-called anti-competitive practices may be viewed quite differently. For example, resale price maintenance may allow manufacturers to provide retailers with incentives to offer higher quality after-sales service.

A review of the Act will need to focus on:

— a review of some of the provisions of the Act, in particular those which proscribe certain practices; and
— the way the Act has been interpreted by the Court and applied by the Commission in particular cases.

The Fair Trading Act came into force on 1 March 1787. It seeks to regulate business conduct in the area of misrepresentation, certain trading practices, disclosure of information to consumers and product safety. In Treasury's judgment many of the provisions in the Act need much closer scrutiny and critical analysis. In particular:

— establishing penalties for non-compliance with uncertain standards of business conduct is likely to be detrimental to business performance;
  directly regulating aspects of consumer information may benefit rhe groups seeking that information at the expense of all other consumers. This could have distributional impacts that are inconsistent with the Government's other social objectives;
— the design of the regulatory regime for product safety and information standards needs the flexibility to take into account the potential for technical innovation, changing values, competing views as to the desirability and level of standards, and the scope for firms to promote standards to their advantage against local and overseas competitors.

A review of company law is currently underway. The introduction of certain regulatory restrictions to company law (for example, the types of obstacles to takeover activity that have been proposed by the Securities Commission) has the porenrial to impose considerable costs on the economy. Expert consideration, which is sensitive to the ways in which costs may be imposed, is required in this area.

Experience overseas with environmental protection legislation is that, if poorly designed, it may impose large costs on industries and consumers while doing little to improve the quality of the environment. There are many situations in which measures such as the granting of appropriate private property rights or the imposition of pollution taxes can lead to much more cost-effective control of pollution than the injunctive remedies which are common in this area.

Finally, regulations governing safety and health can be found under many Acts, as well as in local authority bylaws. Regulations in this area have the potential to impose substantial costs on businesses while not necessarily improving health and safety outcomes. A related issue is the impact of the Accident Compensation Act on incentives faced by businesses to voluntarily undertake safety measures. This Act is currently under review by the Law Commission.

Conclusion

In summary then the priority areas for regulatory reform are:

- liberalisation of the tradeables sector and in particular a reduction in the level of assistance going to import substitution;
- a review of the regulatory frameworks surrounding both public and private sector labour markets and occupational regulation;
- on going regulatory reform in other areas that will contribute to minimising the costs of other adjustments.

Finally, it is important to improve the functioning of the regulatory reform process. The institutional framework within which the Government's reform process takes place should be modified to minimise the scope for regulatory capture. It needs to ensure the development of consistent and clear principles and facilitate detailed attention to hidden effects of regulation. In this process the Economic Development Commission's Regulatory Reform Unit has a role to contribute. Finally, the scope for putting in place greater control and audit of the creation of new regulatory instruments needs urgent and careful consideration.

Occupational Regulation: a Case Study

There are well over 35 different Acts of Parliament which provide for the regulation of a variety of occupational groups ranging from music teachers and lawyers through to real estate agents and accountants. This regulation can either simply set out prescribed rules for the organisation of an occupational group or also involve licensing, whereby the sole rights to perform particular work are conferred on the occupational group. Licensing is pervasive in New Zealand. This section will apply the principles developed to the case of occupational regulation.

The rationale for occupational regulation is to protect the consumer by promoting and maintaining the quality of service in order to avoid severe outcomes such as accidents in the conduct of surgery. There is however an inconsistency between the stated objective of promoting the interests of consumers and occupational licensing which tends to limit consumer options, inhibit innovation and generally protect producers to the detriment of consumer. There still may be some potential role for regulation of the professions, but licensing should only be used if a particular need is shown which cannot be addressed any other way at a lower overall cost.

The central problem faced by consumers is the difficulty of evaluating the skills and performance of specialists. These information problems arise because of asymmetry of information between the specialist and the customer, the absence of repeat purchases and the often long time periods that may elapse before the consequences of a poor service become apparent.

Without state regulation, the common law would serve to protect against professional negligence and misrepresentation while consumer legislation would further tend to counter unfair representation. In comparison to licensing such a system would allow greater scope for innovation, greater variety of service and more competitive pricing. Moreover, it is likely that market mechanisms for ensuring quality of service could emerge such as voluntary occupational associations and firms which act as monitors of employees' performance. Information gathering would also occur via a variety of other mechanisms including for instance rating agencies, the establishment of brand names and trade marks, guarantees of service and reputation effects. However to the extent that the usefulness of information is not diminished by its wide dissemination, or such information is easy to copy or pirate, its distribution may be less than ideal. The relevant question however is what can Government do to improve things?

There are a variety of interventions possible short of licensing. Interventions that seek to improve information flows include the provision of subsidised information and the registration or certification of practitioners. Interventions that act primarily on incentives to improve the precautions that both practitioners and consumers take might include reform of the legal environment such as the law of liability in torts, the possibility of class actions and amendments to the ACC.

Space here does not permit an adequate evaluation of all the alternatives. We shall therefore consider only two, licensing and certification.

Licensing

Licensing involves not only giving licensed practitioners exclusive rights to a title but also exclusive rights to perform certain services.

The major costs of licensing arise from this latter effect. This creates restrictions on competition from para-professionals and between members of the profession. In turn this lessens the incentives to above-average performers and so tends to stultify innovation and change. Nor are poor performers likely to be eliminated as quickly as in a more open market place. Thus restriction is often a less efficient way of protecting the consumer than competition would be.

Licensing further restricts consumer choice. Consumers cannot buy services below a minimum standard so many choose to buy nothing at all. The bundle of skills which a professional has may be of excessive quality or range for the majority of tasks he or she actually faces. Allowing specialisation whereby paraprofessionals undertake routine tasks would be appropriate where competence at a lower level was not impaired by the lack of a qualification and did not require a deeper or wider knowledge. This has important equity implications certain services. Non-certified individuals are not prevented from offering routine services-'paraprofessionalism'.

Certification can be applied to offer more extensive information to the consumer than licensing. For example, varying levels of qualification and performance within an occupation can be graded separately. Certification boards could also rate practitioners according to ongoing qualifications and training rather than the licensing system's use of initial entry requirements.

The key advantage of certification compared to licensing is that by allowing various levels and quality to co-exist, wider scope for consumer choice is permitted. Information on quality is provided but costs are not imposed on those who wish to choose lower levels of service. Certification would further not impede organisational and practical innovation; and by ensuring certified titles are consistently and unambiguously defined, efficient use of labour is not hindered. The consumer is also protected from certified practitioners imposing unnecessary or irrelevant entry criteria or codes of conduct, as they would be free to choose non-certified alternatives.

Conclusion

This brief discussion highlights a number of points:

— a review of regulations in this area is likely to result in beneficial regulatory reform but not deregulation. There appears to be a useful low cost intervention available to government for a number of circumstances involving the use of certification;

— there is no conflict between the values of efficiency and equity, the reform of inappropriate regulation will make useful contributions to both objectives. Reform of occupational licensing has the potential to improve both access to jobs and access to a range of quality services at a lower price. The current regulation may preclude low income people purchasing any service at all by restricting low quality or alternative supplies;

— in some cases the impact of the regulation could be the opposite of what was intended-the standard of service to consumers may have been lowered;

— specific intervention itself costs by crowding out private suppliers.

The process of reform of occupational licensing needs to be carefully managed to ensure that the overall benefits to the community of any change are fully developed and explained to the public. The best approach is probably to first identify what key principles ought to be used in reforming occupational licensing in New Zealand. These should be announced. The Government should at the same time signal that it intends to progressively review all occupations currently regulated on the basis of these principles.

Such a process would ensure consistent credible and comprehensive reform and would signal the Government's intention to treat all groups equally.

LABOUR MARKET

Introduction

Employment is the central means by which people derive income and their material well-being. For this reason the growth of unemployment over the past ten years is of major concern:' Such high levels act as a major restraint on the opportunities open to many people and in a number of cases are a significant cause of reduced living standards.

The last three years have seen some significant changes in the labour market and the role of the Government in this market. The Government has moved away from a centralised approach to industrial relations, and wage-fixing in particular. Instead the people directly involved have been encouraged to assume a greater degree of responsibility for finding solutions for their own specific problems. This is illustrated by reforms in labour relations, where the Government has, for example, stepped out of wage negotiations, introduced voluntary arbitration, made the industrial relations regime more permissive, encouraged adherence to contracts, and made unions more accountable. In the state sector, reforms in pay fixing include introducing the facility for enterprise bargaining and pay to be related to individual performance. In employment and training policy, Access represented decentralisation of assistance with training providers having incentives to deliver effective and adaptable training courses in a targeted manner.

Despite these innovations, there is in Treasury's view still considerable room for improvement in labour market policy, especially in the regulation of both private sector and state sector industrial relations. Adjustment to low inflation and assistance reform does impose short-term costs on the economy. Many of the costs can be seen in the form of higher unemployment. While some of these costs are unavoidable in the sense that people's expectations are slow to adjust to a new economic environment, the regulatory framework of the labour market can have a very significant influence over the ease with which adjustment can occur. Unless the regulatory framework is flexible and permissive enough to allow adaptation to changing conditions, the consequences will be felt in continuing high levels of unemployment, lost opportunities for young people to gain skills, continued slow growth in productivity, and poor economic performance.

This section on the labour market examines the key features of labour market policy, although the public sector labour market has been addressed in some detail earlier in Chapter 2. It discusses initially the special features of the labour market-for example those aspects which tend to make adjustment slower than in other markets, the existence of institutional arrangements which make layoffs more likely than wage reductions for employers seeking to lower labour costs, and why unemployment tends to be more severe among low skilled individuals.

Labour Market Characteristics

New Zealand has historically enjoyed low rates of unemployment. Registered unemployment was never above 10,000, and rarely above 5,000 from the 1940s to 1977, and even when unregistered unemployment and other variations in measurement techniques are taken into account, rates of unemployment in New Zealand were low relative to those of trading partners and other OECD countries. A fully-employed economy not only indicated that the nation was striving to gain the most from its labour resources, but also was an important element in New Zealand's self-perception as a fair and just society.

On the grounds both of efficiency and equity, therefore, the considerable increase in unemployment since 1977 has been a cause of great concern. Registered unemployment exceeded 20,000 in 1778, reached 40,000 in 1780, and doubled again to over 80,000 by the end of 1783; since then it has dipped, but again lifted to over 80,000. When unregistered and various forms of hidden unemployment are taken into account, the total level of unemployment may be considerably above the registered figures. Concerns extend beyond simply the aggregate unemployment level, to its uneven impact on different sectors of the population. For example, half the unemployed are aged under 2 5, Maori unemployment rates are more than three times those of Europeans, and over half the unemployed have no school qualifications. In addition, unemployment has become severe in certain regions, representing a change from earlier patterns, with smaller provincial areas now experiencing much higher unemployment rates than the large urban areas.

It has become traditional to analyse unemployment in terms of its structural, cyclical, frictional, and seasonal components. Recent advances in the understanding of labour market arrangements have allowed this traditional approach, which tends to be somewhat aggregative, to be enhanced by better microeconomic perspectives on the nature of employment relationships, and of the adjustment processes which may generate unemployment.

Analysis of the labour market requires a more complex and specialised framework than a basic supply-demand model. Examples of its special character include the long-term nature of many worker-firm relationships, the investment aspects of these relationships, and the behavioural implications of wage and employment structures.

Two broad areas may be identified that have an important bearing on the nature of an employment relationship, particularly on the durability of this relationship and its wage-determining structure. These areas involve:

- the nature of skills and training required of, and imparted by, the position;
- the monitoring, accountability, and incentive structures of the job.

Skills and Training

Human capital development consists of two major components, those skills that are specific to a particular workplace, and those that are general to a number of organisations. By its very nature, training that imparts specific skills will usually take place 'on-the-job'. The costs and practical difficulties of reproducing such specialised situations away from the workplace means that training tends to be an informal process of 'learning by doing' and 'learning by observation' in the workplace.

The more specific the skills and training, the more valuable individuals become (in terms of their potential output) within the organisation compared with outside. In such circumstances, wage and employment structures will tend to arise which generate durable employment relationships.

In practice, several factors will influence the proportion of training costs borne by the firm and by trainees. Each party's assessment of the probability that the other will sever the employment relationship will be particularly important. Employers would be less willing to invest heavily in employee training if they perceived a high probability of resignations, and trainees would be unwilling to bear training costs if they felt threatened by future lay off. In order to better assess these risks, potential trainees may accumulate information on the general reputation and employment practices of employers, while employers may engage in screening procedures in order to select applicants who, they feel, may form stronger attachments to the workplace.

The outcome of these considerations is that, in the presence of specific investments in human capital, both parties to the employment relationship will carry a share of the risks associated with uncertainty in the workplace. The sharing of both the costs and the benefits of the training processes not only reflects each side's judgment concerning the stability of the arrangement but also, and more significantly, provides both the employer and the employee with an incentive to maintain their relationship through changing economic conditions. In the presence of trade unions, the strength of the employment relationship will also depend on the effects of union bargaining on terms and conditions of employment, particularly redundancy and redeployment provisions.

In contrast with specific training, general training imparts skills that are useful in a number of different organisations. The ability to operate widely available machines or systems of production, occupational skills (for example doctors, electricians) that are valued in various workplaces, and basic work habits of punctuality, reliability and so on, all fit into this category. Even formal education, particularly its more vocational elements, could be viewed as a component of general training.

A great deal of general training is undoubtedly acquired on-the-job in much the same way that specific skills are conveyed. However, unlike specific training, there is also considerable scope for general skills to be learned in other settings. Schools, universities, and technical training institutions would be examples of such facilities, as would smaller training organisations focusing more on certain types of skills.

Employees will generally be able to capture the major share of benefits arising from general training, since competition among employers in the market for their labour services will tend to maintain earnings at a level comparable with the marginal value of output produced. Reflecting the much greater uncertainty of obraining an adequate return from an investment in general training, firms generally will be less willing to finance such training. Instead, trainees themselves will generally pay for a greater proportion of the training they receive. This is reflected in individual willingness to pay for training courses in such areas as word processing, accountancy and electronics.

Monitoring, Accountability and Incentive Structures

Earnings and other conditions of employment will be strongly influenced by the systems of observing, measuring, and eliciting employee contributions to the organisation. If it is straightforward and inexpensive to monitor individual output, then payments may relate to results actually achieved. For example, piece-rate pay systems may be used, or commission payments based on sales.

Similarly, even if individual performance is difficult or expensive to monitor, if the individual is accountable for the results of the employing organisation, or reports directly to a supervisor who can be monitored or brought to account for organisational performance, then payment-by-result will be an available means of determining pay and other conditions of employment. For example, individuals in a professional practice and accountable to customers are likely to receive earnings that reflect the market performance of their organisation.

However, in situations where monitoring methods and channels of accountability are weak, alternative compensation structures will be designed in order to provide appropriate incentives for individual effort and productivity. These arrangements are designed to discourage opportunistic behaviour such as shirking or free-riding on the efforts of others. Two general examples are discussed in this context.

The first suggests that earnings may have a positive effect on productivity if the compensation individuals receive within an organisation is better than they could receive in alternative places of employment: attitudes to work may improve, the costs to individuals of losing their jobs (for example due to poor organisation results) are greater, and recruitment may be easier. Hence, a firm may seek to establish a reputation of being a 'good employer' in its local labour market, as part of an incentive structure for encouraging greater output from its workforce.

The second, and more general, mechanism for eliciting effort when individual productivity is difficult to monitor is for the organisation (including managers, workers, and unions or other forms of collective organisation) to foster a co-operative working environment within which the processes of team work and peer review largely replace the need for individual supervision. An employment relationship may include promotion from within the organisation, a rising earnings-seniority profile, plus a combination of explicit rules and implicit understandings concerning procedures to be followed during changing economic conditions.

Employment Relationships

The various levels of job specific skills and method of monitoring performance can combine to produce a range of employment relationships. Some examples are provided. All to varying degrees will be influenced by factors common to most employment relationships, such as the costs of hiring and firing, the need for and level of redundancy pay, and concerns about reputation.

i When skills are predominantly firm-specific, and individual productivity is difficult to monitor, an 'internal labour market' will tend to arise within an organisation. This is likely to be characterised by a hierarchy of jobs, promotion from within the organisation rather than from without, a considerable degree of employment stability over changing economic conditions, and earnings levels for incumbents that are shielded from competitive forces arising in the outside labour market. Earnings tend to be related more closely to positions than to individuals, and reflect internal equity considerations, customary practice, and motivational objectives. Large manufacturing plants provide examples of this employment relationship, as does the public service. In this second example, it is noteworthy that even without the relatively restrictive regulatory framework currently in place, internal labour market characteristics would tend to arise as a result of skill and incentives considerations.

From an efficiency perspective, these arrangements are designed, in part, to provide for the smooth acquisition of skills, including their transmission from the incumbent workforce to trainees. Seniority provisions provide protection that encourages knowledge to be conveyed to trainees. The hierarchical structure of jobs and wages, and promotion features can be viewed as efficient devices for encouraging the formation of a stable, co-operative, and cohesive workforce.

If the organisation suffers a downturn in the economic conditions it faces, both parties to the employment relation will attempt to preserve their investment in specific skills by maintaining the relationship; promoting durability in such agreements. However, if reductions in labour costs become essential, these are, more likely to be effected through layoffs than through wage cuts. Reasons for this would include concern about the effects of reduced wages and salaries on incentives to train and the associated consequences for long-term productivity.

ii When skills and training are predominantly general in nature, and accountability or monitoring mechanisms are clearly established, the employment relationships that arise will be weaker and more susceptible to changes to market conditions. Low-skilled, and often seasonal, labour and some highly-skilled professionals that are rewarded on a piece-rate basis provide examples. Downturns in organisational earnings, for example, may lead directly to salary or wage reductions for employees, since pay is based on results (that is, the value of output) rather than on other incentive or co-operative considerations. If there are impediments to wage reductions, cutbacks in the workforce may readily occur; minimum wage legislation, and negotiated restrictions on wage flexibility, are particularly significant in this regard.

iii A combination of specific skills and good systems of monitoring or accountability will tend to produce durable employment relationships, and reward schemes based on results rather than on co-operation requirements. A typical set of examples would be provided by the relationships that develop in smaller organisations producing specialised goods or services, such as in high-technology areas. Skills specific to the organisation tend to develop, and the small size of the workforce leads to clearer methods of establishing monitoring and accountability systems. As a result of these circumstances, employees may develop strong ties to the organisation, that are maintained through changing economic conditions. Only in severe downturns would employmenr relationships tend to be broken.

iv When skills are more general and monitoring is difficult, weak employer-employee bonding is likely, and there will tend to be a reliance on co-operation-inducing pay structures rather than payment-by-result. Unskilled labour working in large organisations would often fit into this pattern, as is reflected in this group losing work when downturns occur. Similarly, seasonal and vacation workers in rerail stores and production plants may have these employment characteristics.

Unemployment

The preceding discussion of employment relationships can be brought together and summarised by considering the sources and incidence of unemployment that will tend to arise from the various arrangements that have been outlined. When skills are primarily of a general rather than firm-specific nature, relationships between employees and employers are likely to be less durable in response to adverse economic conditions. With less investment in the relationship, firms will be less inclined to retain current employees if it is not in their self-interest to do so, and employees, perceiving better prospects elsewhere, will be more willing to pursue these alternatives.

The impact on unemployment of weaker job attachments may be most noticeable amongst those who have lower levels of general skills. Higher-skilled individuals will tend to have more, and better, alternative job opportunities if their current employment arrangement ends, including the resources to move to locations where jobs are to be found. In addition, structural and cyclical downturns may be more likely to affect the low-skilled than those with occupational qualifications-professionals in trade and personal service areas may, for example, be relatively immune to the adverse effects of economic fluctuations.

Where inadequate monitoring and accountability systems lead to structures that encourage co-operation, layoffs may be a more likely choice than wage reductions. The choice will. be more readily exercised in the case of generally skilled workers, with those who have specific skills benefiting to a greater extent from job security arrangements.

Discrimination

The existence of discrimination on the labour market experiences of certain groups can also be discussed in the context of the framework outlined above. Although discrimination, whether against women, members of minority groups, certain age groups, or the handicapped, can potentially affect the earnings and employment conditions in any of the employment relationships described above, the opportunity for certain forms of discriminatory treatment may be greatest when employers believe they bear more of the burden of uncertainty concerning individual productivity. It is in these conditions that co-operative arrangements rather than result-based pay systems are used, and this is also when screening devices may be used by employers in an attempt to reduce the costs of uncertainty by selecting individuals with characteristics perceived as more conducive to productive contributions to the organisation. So-called 'statistical discrimination' arises if race, sex, age, or other characteristics are mis-applied as proxies for productivity, and the uneven incidence of unemployment may, in part, reflect unequal opportunities of individuals to pass screening procedures and gain selection to secure jobs. To the extent that a history of unemployment is itself used as a selection criterion, reducing the chance of success in a job application, a vicious cycle may develop in the unemployment experiences of disadvantaged groups. The failure of individuals to gain access to jobs offering investments in specific training, such as positions in internal labour markets, will also perpetuate the disproportionate impact of economic downturns on certain groups.

Conclusion

This section discussing the labour market, and the Government's role in it, has been a brief survey of a complex market, in which the effects of government policy are often subtle and typically far-reaching. Key features of the market are first, that employment is the central source of people's incomes and hence that job opportunities and earnings are crucial to people's lives; and second, that the Government, in setting the regulatory framework and through other interventions, has a very significant effect on labour market performance.

The nature of employment contracts means that quantity adjustments will often be preferred to price (wage) adjustments, and that under internal labour market conditions, long-term contracting considerations may dominate employers' responses to exogenous changes. These observations have special significance in the current economic context, with New Zealand going through a major process of structural adjustment and disinflation. Also noted were some explanations as to why the burden of unemployment tends to fall on certain groups—especially those with general rather than specific skills-and how regulatory restrictions on price flexibility can cause the impact of a downturn to fall most severely on low-skilled individuals.

PRIVATE SECTOR LABOUR MARKET REGULATION

The labour market is a critical part of any economy. The more it is able to respond to changes in international and domestic market conditions, the better are income and employment outcomes likely to be. The events of the last decade have shown how the New Zealand labour market, by repressing efficient adjustment processes and repressing market signals through rigid institutions, a complex structure of bargaining, centralisation of wage fixing, and frequent direct intervention, has contributed to adverse outcomes such as a rapid increase in unemployment and low productivity growth. The New Zealand labour market has like other markets been unable to adjust quickly enough. The problems of poor earnings and employment growth must ultimately lie in our inability to adapt, and cannot be ascribed to exogenous changes.

Deficiencies in labour market regulation have contributed significantly to the rigidity of New Zealand's labour market institutions and processes, and our slowness in adapting to change. It is important that the regulations which govern the use of labour in production are both permissive and enable workers to take advantage of change. Where change means job losses from declining industries, workers need union leadership skilled in negotiating redundancy and redeployment deals. Conversely, where change creates new jobs and opportunities for increased productivity and profitability, workers need union representation that can win them a share of the benefits, and not stand in the way of productivity improvements that will allow real wages to rise.

Labour market regulation needs to be permissive enough to allow arrangements to emerge that are mutually beneficial to workers and employers. Some of the special features of labour market contracting, and their diversity, were described in the previous section. Given this diversity, it can be expected that a wide range of contractual arrangements will evolve, and accordingly, a flexible regulatory framework will be necessary to generate appropriate arrangements. Thus, for example, where an employment relation is costly for both parties to terminate, and 'exit' becomes an expensive means of expressing dissatisfaction, an internal labour market may arise, with complex contracting between union and employer. In this context, an enterprise union may be the most effective means by which the collective voice of employees can be heard. If the industrial relations regime prevents enterprise unions from emerging, the result may be-less effective communication in the workplace and lower productivity.

The regulatory environment should also ensure that organisations operating in the labour market face incentives to adapt over time. Employer and union organisations are subject to the same sorts of problems as organisations elsewhere in the economy—principal-agent problems, for example-and if they are -to contribute to better labour market performance, they need to be kept under pressure to adapt. They should have the incentives to express their members' preferences clearly and should not be impeded in the way they respond by artificial constraints. The institutional environment in which they operate, including the degree of contestability in that environment, will strongly influence the extent to which they face these incentives and are thereby motivated to adapt and provide the services that members want.

In considering the regulatory environment, it should not be assumed that efficiency is the only relevant criterion. Equity considerations are clearly important, especially in a world where perceptions of fairness have productivity consequences. However, we see equity objectives as being best met not through detailed (typically inflexible) labour market regulation but mostly through other means, especially the tax/benefit and education systems. Regulatory interventions in the labour market which attempt to achieve some equity objectives, or 'sub-objectives' such as national wage rates, can have high costs in terms of economic performance and therefore employment opportunities for disadvantaged groups. Conversely, the consequences of a better functioning market are felt in widespread income growth and lower unemployment. These are probably, in the end, more important for achieving greater social equity, than are specific regulatory measures that can severely inhibit market exchanges, with largely invisible costs and unclear benefits.

Institutional Environment of the Labour Market

The Government's fundamental role in the labour market is to allocate property rights and establish the basic institutional framework which accommodates and shapes contracting in the labour market. It does this in two main ways. The first approach is to rely on common law (implicit intervention); the second approach is to promulgate laws (regulation).

The common law forms part of the general structure of property and human rights in our society but nevertheless clearly affects labour market contracts. For example, in New Zealand unions are not immune from tort actions if they act in restraint of trade, whereas in the UK they do enjoy immunity. The Labour Relations Act is the most important of the laws and regulations with which rhe Government sets the institutional framework. While in some respects the Act represents an optional framework for labour market participants to operate in, in many aspects the Act supplants and restricts possible voluntary solutions. In fact, for the majority of those involved in private sector employment relations the Act defines among other things how employee or employer groups can form, how an employment contract is negotiated before it can be regisrered and becomes a legally binding contract, and sets certain minimum standards for the majority of the workforce. The State Services Conditions of Employment Act covers similar issues in the state sector. In addition, terms of employment are set down in the State Services Act and the State Enterprises Act covers some aspects of employment in state owned enterprises. It is important to note that these are all interventions that determine the institutions governing labour market contracting. They can be distinguished from other interventions such as the education system and the tax/benefit system, which, while very significant for the labour market, do not directly shape employment contracting.

The Labour Relations Act 1987 has redefined property rights and permissible contracting practices in the labour market with the aim of providing a more flexible environment in which employers and employees can contract according to their needs and objectives. In assessing the new Labour Relations Act it is useful to review the objectives that ought to guide regulation in this area and consider a framework for analysing labour market regulation. This will enable a brief review to be conducted of the failings of the old Industrial Relations Act and lead to a discussion of what reforms are required to the current Act.

Framework for Analysing Labour Market Regulation

In the first part of this section the general framework which Treasury has found most helpful for looking at the labour market was outlined. It essentially starts from the practical observation that in the real world, free auction markets are comparatively rare. The problems which give rise to this include the costs of contracting arising from opportunism, uncertainty, market power, and information and measurement problems. In place of decentralised auction markets a variety of different organisational forms and arrangements have evolved to minimise these costs of contracting. For example, unions can be seen as efficient organisational devices that can in some circumstances reduce some of the problems inherent in the wage-labour employment contract. So long as unions are both effective and representative, they are likely co have a positive role in lowering the cost of contracting. They can overcome the 'collective choice' problem, where individual employees have few incentives to try to get unsatisfactory features of an employment relationship changed, but the union can act collectively to do so. Thus they can efficiently provide information to employers about workers' views, negotiate in one simple setting a number of different contracts, and reduce the risk of exploitation by increasing the bargaining abilities of workers. The exact arrangements which are most efficient in any particular situation will vary through time and from industry to industry, and depend ultimately on the nature of the transaction, for example whether it is for work involving specific or general skills, or short-term or long-term work.

The basic organising principle for a sound system of industrial relations should be voluntary contracting. Voluntary contracts freely entered into by equal parties are (subject to the caveats below) likely to be both efficient (as the parties have the information and the incentives) and equitable (in the sense that the parties involved can best judge the impact of the contract and can correct unfair or unexpected outcomes in subsequent negotiations). The most effective labour market regulations are therefore likely to be those which adopt as their fundamental objective the creation of such a framework and encourage equal parties to negotiate agreements to which they are committed.

Like any general proposition, the proposal that voluntary contracts freely entered into are likely to be both fair and efficient is only true if certain preconditions are met. In particular these include:

- i that there is an appropriate balance of bargaining abilities between workers and unions as well as unions and employers which may have implications for intimidation, victimisation and so on;
- ii both parties face the costs and benefits of their actions so that, for example, free riding, agency costs and entry and exit barriers are minimised;
- iii that there are no unreasonable difficulties or barriers to the ability to contract so that, for example, the regulatory framework is relatively certain, simple and serves to lower contracting costs.

The problem for policy is to assess whether or not the available policy instruments, such as the determination of the right to organise and post-entry compulsory unionism, will be effective in achieving a reasonable balance between these objectives. This is of course difficult where policies which achieve one objective can often conflict with another. For example, it might appear desirable to employ compulsory unionism to increase the bargaining abilities of groups of workers in some circumstances, but this could conflict with the objective of ensuring that unions face the consequences of their actions by allowing workers to leave unions. Moreover the implications of and need for policies will change as circumstances alter. Considerable care is thus required to avoid constraining the evolution of bargaining units and contract arrangements in response to changes in the environment.

Evaluation of the 'Old' Regime

A major failing of the regulatory framework dating from 1894 was that it was excessively prescriptive about the forms and processes to be followed in bargaining. Blanket award coverage meant that those affected by the wage negotiations often had little influence on them. Agreements did not reflect the circumstances of individual firms and while blanket coverage lowered the negotiation costs incurred by unions it raised the costs faced by individual employers. In the handling of disputes the Arbitration Court tended to hold employers to their contractual obligations while not enforcing similar requirements on unions, lowering unions' incentives to honour contracts. Union registration rules, while protecting existing unions also inhibited their ability to adapt and reduced the incentives on them to adequately meet the needs of the workers. Overall the regime has also had an undesirable bias against alternative employment contracts (worker participation for example), and has inhibited the ability of labour market organisations to adapt to changes in the environment and the needs of members.

Evaluation of the 1987 Act

The extent to which the new Labour Relations Act 1987 has met the criteria ser out above and solves the problems that arose under the Industrial Relations Act 1973 and earlier regimes, is to some degree dependent on how effectively the parties use the more flexible contracting provisions. It will take some time for this to become apparent, especially given the slowness with which attitudes appear to change in the industrial relations arena.

However, in our view the Act fails to address in an adequate manner the single most serious problem with current law-the structure and level of bargaining which the regulations have created and support. This breaks down into two key areas, union organisation rules and bargaining rules.

Union Organisation

As noted above, it is vital that unions are able and willing to adapt to changes in the working environment since it is in their members' interests that they do so. Accordingly it is important that they have strong incentives to do so. In our view, the union registration provisions have nor been relaxed enough to significantly increase contestability, a crucial incentive, and reduce the costs imposed by compulsory union membership. The ability to form new union structures is substantially limited by the very restrictive criteria for forming a new union and the minimum membership (1,000) requirement before a union can be approved for registration. A new union can be formed only where the workers are nor covered by an existing award or agreement. Given the ability, under the Act, of a union to perpetuate an award, a union can effectively deny members the opportunity to form a new union. In addition, a group of workers has no right to directly seek coverage by another existing union. Only *unions* are given rights to seek changes in the coverage of existing unions. The costs facing a union seeking to take this course are also high under the Act involving unnecessarily complicated balloting procedures.

These provisions have the tendency to reduce flexibility in the structure of bargaining and therefore the efficiency of contract negotiation. To some degree they also encourage the retention of blanket awards, irrespective of their suitability in a particular industrial environment. This leads to the level of bargaining being too centralised. Union members in particular firms generally will not have enough influence to affect the union's decision about the level of bargaining (or the numbers to form their own union). If the union is more concerned about general conditions, rather than those suitable in a particular case, this may produce high costs in terms of employment security.

Bargaining Rules

Clearly the effect of union registration rules in supporting inefficient bargaining structures are reinforced by bargaining rules and in particular blanker award coverage. Blanket coverage has raised the likelihood that for a given firm wages will be out of line with productivity, and that centralised negotiations will ignore relevant information, with agreements being ill-suited to a firm's needs and therefore likely to endanger the job security of its employees. While provision for separate negotiations or opting out has been included in the new legislation it is dependent on a union agreeing to a particular firm's exclusion from the (national) award. Exclusion is likely to be resisted by a union on the grounds that it weakens the (national) award. The multi-union firm will also have difficulty in obtaining exclusion from national awards and moving toward more decentralised plant based bargaining because of the need to gain approval for separate negotiations from all unions represented in the plant. Nevertheless, the new Act makes clear when a union can exclude an employer (before award negotiation commences) and what rights an employer has if a union asks for exclusion after that point, by clarifying each party's rights and obligations.

Direction of Future Reform

Our assessment, then, is that the new Labour Relations Act, while going some way towards bringing labour relations into line with the demands of the present economic environment, still has two major areas of deficiency, leaving aside other aspects of the new Act which in our view may impair the evolution of berrer industrial relations practices and hence labour market performance. In the first major area of concern we see a need to constrain the ability of groups of employees or unions to create 'barriers to entry' which increase their bargaining power at the expense of other workers, particularly the most disadvantaged. Blanket award coverage therefore is of central concern. Second, there is the need to minimise principal-agent problems within unions, by aligning union officials' and members' interests, implying that a review of union registration procedures is required.

Blanket award coverage is in our view the most unsatisfactory element in the current Act. The current inability of employers and workers to agree to wages below an award minimum (or some rate grounded on this minimum) means rhe opportunity cost of idle labour resources and the equity costs implicit in the uneven incidence of unemployment are unlikely to be adequately accounted for. Instead, centralised negotiations are likely to be the norm and generate uniform awards that are insensitive to the special circumstances of particular workers, small firms and depressed regions. We consider that if it is not possible to abolish blanket coverage then there is at least a need to statutorily impose appropriare restrictions on the scope of blanket coverage-for example, to have awards extending only to 'like' employers, or only within regions. In addition, individual workers' rights to obtain exemptions from awards should be clarified, for example, an exemption for the long-term unemployed. Finally, individual employers should be given the right to apply for exemptions from award coverage, upon clear grounds, for example if employers are willing to enter into profit sharing arrangements with their workers or if their businesses are in difficulty or newly established.

In the area of union registration, allowing employees to determine the type of union structure would firstly make clear to an employer that the employees support the union, and secondly, ensure the objectives of members would be accorded more weight. Also, by removing the restrictions on registration, the costs associated with compulsory union membership would be mitigated. The retention of compulsory unionism, it should be noted, is justified only so long as the costs of being required to join a union are offset by the gains elsewhere. We are doubtful whether the correct balance has been struck in this regard, given that the scope for contestability is too low at present.

In summary, the most important provisions envisaged by Treasury for a reformed system include:

— promoting more effective unions by recognising the righrs to organise and bargain; and
— the removal of blanket award coverage to facilitate the evolution of more satisfactory bargaining units and to allow grearer scope for employees and employers to negotiate mutually advantageous bargains (by taking greater account of the particular requirements and conditions of different workplaces).

These provisions would go a considerable distance towards permitting the degree of flexibility needed to recognise and where appropriate rake account of the different circumstances in different workplaces, while simultaneously improving the employment chances of unemployed workers.

Conclusions

As the New Zealand economic environment changes, it is important that labour market regulation be flexible enough to allow it to adapt to changing conditions and objectives of both employers and employees. The failure to adequately shape the legislative environment will result in job losses, forgone opportunities to improve productivity, and poor economic performance. While on the one hand the new Act does promote more flexibility in labour relations, on the other hand the Act in our view fails to measure up in the key areas of blanket coverage and union registration. It therefore remains to be seen whether the new Act will generate a significant improvement in labour market performance. Outcomes will depend on the extent to which employers and unions are willing to test its scope in arranging their affairs and negotiating awards and agreements.

Other Regulatory Issues

The earlier discussion on the nature of the labour market described several employment and compensation arrangements that would tend to arise in response to characteristics both of the workplace and of participants in the employment agreement. The current section describes two forms of government intervention in the labour market, one proposed, the other in place, and considers briefly their implications for market arrangements. These interventions, by their very nature, will tend to alter the nature of employment agreements that would otherwise be reached between employees and employers. The question therefore arises as to whether the benefits of regulatory interventions of this type exceed the costs imposed, in terms of efficiency and equity of labour market processes. The proposals also raise a need for more general analysis of the nature of the problems and the extent to which other interventions might be more effective.

Comparable Worth

Over the last few months the idea of 'comparable worth' or 'equal pay for work of equal value' has received considerable publicity. Advocates of reform in this area see comparable worth as a fairly natural 'next step' to supplement the provisions of existing equal pay legislation. We accept that discrimination against particular groups within the labour force is likely to exist. The earlier discussion suggested that one reason for this may be employers misconstruing certain characteristics as providing information about a person's likely productivity.

While differences in the occupational and earnings structures of males and females are undeniable, and require that Government take a keen interest in this area for equity reasons, there are however a number of problems involved in implementing such reforms in pay-determining procedures. Our views on this general issue are that any benefits would need to be weighed against the following factors:

- i the effects on wage costs and employment patterns that would arise as a result of comparable worth proposals: perversely the implementation of comparable worth could have a negative impact on some members of the group that the proposals are intended to help. Although some women in predominantly-female occupations would receive higher earnings, others would find their opportunities for employment and income diminishing: firms will tend to substitute away from labour that has been raised in price relative to other forms of labour and capital, and the quantity of output demanded from firms which have been forced to raise input costs and output prices will tend to fall. This would act to slow the strong growth in female participation and employment that has been occurring in recent years. Moreover, the wage adjustments that would take place under comparable worth legislation could provide misleading signals to labour market participants. For example, individuals might face incentives to develop skills for which there were declining employment opportunities;
- ii at a technical level, comparable worth reforms would require the identification and weighting of a limited number of characteristics common to all jobs under review; this would create daunting information problems in view of the wide range of skills, responsibilities, and

other requirements and functions of jobs in the labour market. Moreover, the evaluation of positions in terms of these characteristics would risk being a highly subjective and arbitrary process;

iii problems of a dynamic nature are likely to arise: wage rates based on the overall 'job scores' resulting from formalised evaluation procedures, would imply a system of rigid relativiries between positions; it would not reflect market supply and demand conditions with respect to different occupations and would therefore be unresponsive to structural economic changes affecting the labour market.

Our assessment is that government intervention of the type suggested by comparable worth advocates risks being inconsistent with the general thrust of government policies to make labour markets more reflective of and responsive to changes in underlying economic conditions. Any assessment of equity gains should therefore be weighed carefully against the costs that comparable worth regulation may impose. Furthermore, alternative interventions should be considered. More generally, though, it is important that the Government ensures that males and females have equal access to the educational and training resources required for different occupations. This includes those in 'non-traditional' areas, with the opportunity to pursue the incentives which the labour market currently places before them. The Government may also have a leadership role in terms of providing information. This might include information about different job opportunities, breaking down the rigidities that arise from social stereotyping and conditioning, and providing other forms of encouragement to women (and many men also) to consider a wider range of options than they might otherwise have done.

In short, while we strongly agree with the need to identify and eliminate discriminatory forces that lead to differences in the occupational and earnings attainment of males and females, we are concerned that comparable worth is not the most appropriate means to this end.

Minimum Wages

Over the last three years the statutory minimum wage has increased by more than 100 percent, from $100 a week in 1784 to $2 10 in 1987. Over the same period the average ordinary wage increased by 44 percent, and the minimum wage is now around 50 percent of the average. Similarly, the real minimum wage has increased significantly.

Proponents of minimum wage provisions claim that they fulfill a number of objectives. The most commonly cited are those of ensuring workers earn wages which will give them a reasonable standard of living, redistributing income to low income earners, preventing workers from being exploited, and making certain that individuals have incentives to move into employment rather than remaining on social welfare benefits. However, we do not consider that minimum wage provisions achieve any of these goals successfully, and think that there are more effective means of doing so. Furthermore, a minimum wage has distortionary effects in the labour market which are likely to hinder long term employment prospects and harm the very workers that the policy is designed to assist. In order to illustrate this, the general effects of a minimum wage are outlined below. This is followed by a brief assessment of the appropriateness of such provisions for meeting the objectives outlined above.

A minimum wage which is operative pushes up wages at the bottom end of the scale. This in turn depresses margins for skill or ratchets up the whole wage structure. Both these effects put jobs at risk and act to retard growth in employment by increasing the costs of employing unskilled labour and reducing the incentives to develop skills. Moreover, it is the most disadvantaged-the young, the unskilled, the disabled, ethnic minorities-who are most likely to suffer from the decreased job opportunities.

Empirical evidence on the disemployment effects of minimum wages is mixed, and depends to some extent on the particular study method used. However a 1780 survey of Canadian and American studies concluded that on the basis of available findings it appears minimum wages have reduced employment, especially of teenagers. Studies undertaken in North America suggest that on average a 10 percent rise in the minimum wage would result in a decline of teenage employment of around 1 percent. While the minimum wage in New Zealand does not at present cover teenagers, we consider analogous problems may be created for those in their early twenties, and to the extent that adult wages have an influence on youth wages, teenage employment will still be affected. From the more recent work it also appears that the disemployment effects of minimum wage revisions do not occur immediately. The effects are lagged, and often rhe time lags can be long.

A minimum wage also affects more than just levels of employment. Employment contracts encompass a wide range of factors including the amount of training provided, working hours and working conditions. By setting a minimum wage the Government restricts employers' decisions on these other factors. For example, a young worker may be willing to accept a lower wage initially, in return for on-the-job training which will increase his or her lifetime earnings. However, a minimum wage may make this impossible. Since the appropriate mix of these factors depends on the particular conditions and preferences of the people involved, they should be decided in decentralised negotiations, not by government regulation.

The above discussion suggests that minimum wages have considerable distortionary effects on the labour market, and may decrease long term employment and output prospects. If minimum wage provisions achieved significant equity objectives, which could not be achieved in any other way, there might still be an argument for implementing them. However, we do not consider this to be the case.

The first objective of a minimum wage mentioned above, was to ensure workers received a reasonable wage, and perhaps more generally to redistribute income to low income earners. However, claims that the minimum wage can fulfill such roles ignore the fact that those individuals in low paid occupations have very different characteristics as regards dependants, assets and other income. Thus the minimum level of wage-income they need to sustain some basic standard of living is very different. Any flat rate which is adequate for the most needy may be excessive for other less disadvantaged workers.

Similarly, many people who have low incomes do not benefit from a minimum wage. These people include not only part time workers, those with sporadic employment, and the self-employed, but also those who lose their jobs because of the minimum wage and those who face restricted opportunities for training and thereby for increasing future earnings. It is interesting to note that a study undertaken in 1776 of the income distribution effects of increasing the minimum wage in the US, found that if the minimum wage was increased by over 50 percent, with constant coverage and compliance rates as well as stable levels of employment and hours worked, the poverty rate would fall only by around 1 percent.

Given these problems, we consider that there are more appropriate ways of safeguarding people's incomes, which are better targeted and have fewer distortionary effects. Family Support and the Guaranteed Minimum Family Income already provide income support for low wage earners with dependants. Similarly, people without dependants who have physical or mental disabilities can receive benefits, and wage earners without dependants can receive an accommodation benefit. It may be that a small group of low income earners without dependants would not be able to earn adequate income in the absence of a minimum wage. However, this would be better remedied by introducing an income top-up scheme for these people, rather than by continuing to enforce minimum wage provisions.

The second justification for the minimum wage was to prevent workers from being exploited by employers. However, as shown above, there are many other factors to an employment agreement than just the wage, and it is not obvious whether workers being paid a low wage are being exploited, or whether they are receiving an amount which is appropriate, given the training they are receiving and their current productivity. Setting restrictions is therefore more likely to limit workers' choices than safeguard their rights. Rules governing the bargaining and enforcement of wage contracts may be more appropriate in this context, rather than restrictions on wage agreements.

To sum up, minimum wage regulation suffers from the same difficulties facing comparable worth regulation. In our view it does not pass a cost/benefit test, particularly given that most of the costs are likely to fall on those in low-paid occupations or those marginally attached to the workforce. In addition, it is likely that its objectives could be berter achieved by other means, such as income assistance.

Conclusion

The diversity in labour market contracting-from casual short-term contracts to long-term 'relational' arrangements-requires that the regulatory framework established by the Government be permissive and flexible, rather than prescriptive and costly to work within.

This in turn means that industrial relations legislation should start from the premise that voluntary contracting is likely to be both fair and efficient, if certain preconditions are met, and on that basis regulation should avoid constraining the ability of employers and workers to develop arrangements that are mutually beneficial. Accordingly, probably the most important requirement is that regulation allow satisfactory bargaining units to evolve.

We have concerns about whether the Labour Relations Act goes far enough in this important regard. While the Act does promote more flexibility in industrial relations, it fails to measure up in the areas of blanket coverage and union registration. The potential cost is continued poor labour market performance and an unnecessarily protracted process of economic adjustment and disinflation, with the unemployed and the low-skilled bearing a disproportionate burden.

Other regulatory interventions-'comparable worth' proposals and the minimum wage-were briefly considered, and the conclusion we draw is that, while the goals of these interventions may be accepted, the apparent effectiveness of such interventions in advancing equity objectives may be illusory. The costs of those regulatory interventions can be extensive and far from obvious, and the key question to be addressed is whether alternative interventions to achieve the stated objectives might be more effective.

EMPLOYMENT AND TRAINING POLICY

Employment Policy

Over the last three years there have been considerable changes in employment policy, resulting in better targeting of employment assistance, and more efficient utilisation of resources. The changes reflected a view that increases in total employment through subsidised employment programmes were unlikely, and that the old fully subsidised employment schemes were a large drain on government expenditure while doing little to increase the long-term employment and income prospects of the unemployed.

The principal aim of present employment policy is to improve the employment opportunities of the most disadvantaged job seekers. This aim recognises the severe limitations on the effectiveness of expenditure programmes in the labour market. For example, subsidised employment programmes will to some extent fund jobs which would have been created anyway, cause a misallocation of resources as employers use the subsidies to offset the general costs of production, and crowd out private sector expenditure.

Given these adverse effects we do not think employment schemes increase total employment. As well as adopting realistic aims, it is important that employment programmes are structured so as to minimise these adverse effects. This can be done by targeting expenditure strictly on the disadvantaged and structuring programmes so that those delivering the schemes have incentives to do so efficiently. For example, in the case of subsidised employment schemes, partial subsidies should generally be offered, which recognise that most workers do provide output and so produce revenues for the employer. Other aspects of programme design need to pay attention to incentive and targeting features, too. For example, the level of subsidy should be greater for the more disadvantaged job seekers, the subsidies should be of finite duration, and they should decrease over time. This gives employers incentives to employ the most disadvantaged and to increase the productivity of their subsidised workers.

We are also of the view that the scope for employment programmes to increase the efficiency of the labour market by promoting a more mobile labour force is limited. However, some efficiency gains may be achieved by reducing the costs of job search, particularly for those seeking employment opportunities in different regions.

We consider the present direction of employment policies in New Zealand is broadly consistent with this approach. The Job Opportunities Scheme (JOS) is generally in line with the structure outlined above, providing subsidies which aim to compensate employers for perceived productivity differences among job seekers; mobility assistance provides help for disadvantaged job seekers to acquire information and search for work in other areas; and the Employment and Vocational Guidance Service ensures that all the unemployed have access to information and advice on job opportunities.

However, in our view there is still scope for further reform of employment programmes. Some incentive features of JOS could be improved. It may be desirable to increase the incentives on the Employment and Vocational Guidance

Service to place unemployed individuals by enabling private organisations to provide competing placement services. We also think it important to keep a balance between subsidised employment programmes and training programmes, given that the former may have a role in maintaining the long-term unemployed in the effective labour force during an adjustment period of high unemployment. At present the balance may not be. optimal.

Training Policy

Along with the major changes in employment policy, there has been an increasing emphasis placed on helping the unemployed through training programmes, notably Access. As with employment programmes, training programmes have been restructured so as to deliver training in a more flexible and efficient way which better meets the needs of the disadvantaged. As was noted earlier in this chapter, employers and workers will generally have incentives to engage in training. However these incentives are weaker in the case of general training; in cases where individuals because of their background lack an appreciation of the benefits of training, and face higher information costs; and where individuals lack the ability to pay. Thus, there is potentially a role for the Government, on efficiency and equity grounds, to provide targeted training assistance.

Access has many positive features, especially the incentives it gives for training providers to contain the costs of courses, focus on outputs, and cater for the disadvantaged. However, we consider that further improvements are possible, particularly in better defining the objectives of the programme, and improving the incentives on trainees to weigh up the costs and benefits of different oprions. The principles embodied within Access could also be applied to other areas of post-compulsory education than just training for the unemployed, in order to promote more flexible and responsive education opportunities.

The principles embodied in Access contrast with some other training policy interventions, in particular the large number of regulations affecting private sector training. Measures through which private sector training is regulated include the Trade Certification Act, the Vocational Awards Act, the Apprenticeship Act, as well as a variety of other Acts which provide for the regulation of particular occupations such as plumbers, electricians, nurses, engineers, architects, lawyers and doctors.

There may be a role for the Government to set minimum standards for training courses and to provide information on them. However, any review of regulation in this area should take into account the incentives on employers to co-ordinate and provide training, and the limitations on the ability of centralised bodies to determine what training is appropriate. Whether or not the Government should fund organisations to advise employers on training should, for example, take into account the likelihood that in the absence of 'free' services, private 'rating' agencies would develop, to supply both employers and prospective trainees with information on the content and quality of different courses.

TAX POLICY

Overview

Substantial improvements to the tax system have been made over the past three years. These have reduced the efficiency costs of the tax system and enhanced its equity. In particular:

i a second broad tax base was adopted with the introduction of the goods and services tax (GST). This increased the revenue-raising capacity of the indirect tax system and facilitated changes to other indirect taxes and to the personal tax and benefit systems;

ii marginal rates of personal tax were lowered, reducing the efficiency cost of the income tax system, including the incentive to avoid and evade;

iii the personal income tax base was extended by removing a number of unjustified concessions and by the introduction of the fringe benefit tax;

iv Family Support was introduced to assist families on lower incomes;

v substantial concessions to farming, bloodstock and forestry industries, together with accelerated depreciation provisions and export subsidies were abolished or are being phased out. Similar changes are proposed for petroleum exploration and development. A new accrual regime aimed at better matching of income and expenditure relating to financial arrangements has been implemented. In addition, changes to the taxation of international income and expenditure have been announced. All of these moves are expanding the business income tax base and reducing the distortions caused by the tax system; and

vi an imputation system of company and shareholder taxation is to be adopted with a view to taxing income of companies, as far as possible, at rates applicable to their shareholders.

Despite the progress which has been made in reforming the tax system, much remains to be done to ensure that it plays a full part in improving community welfare.

Measured against the recognised attributes of a good taxation system, as discussed in the 1984 post-election briefing, the main problems which need to be addressed further are as follows:

- i the effective rates of tax on business income are still too variable, reflecting remaining specific concessions, deficiencies in the Income Tax Act and the inherent difficulty of applying an income tax to all activities;
- ii effective marginal rates of personal income tax are also too high and uneven, with adverse consequences for the disincentive to work, to invest, to train and to take risks;
- iii selective indirect taxes on some commodities are inefficient; and
- iv the operation of the tax system is impeding taxpayer co-operation.

Taxes impose economic costs on the community in excess of the revenue raised. These arise from their impact on the behaviour of businesses and individuals. Taxes on income, for example, discourage work, saving and investment and encourage tax evasion and avoidance.

Research has been undertaken overseas with a view to measuring these costs. While such studies do not claim to take account of all costs and while acknowledging the measurement problems involved, they typically find that the economic cost of raising an additional dollar of tax revenue is between $1.25 and $1.70. One study in Sweden, where the effective marginal tax rate of the average taxpayer is about 70 percent, estimated the cost of raising an additional dollar of tax to be as high as $3.00 to $7.00. While the welfare cost of raising additional tax revenue in New Zealand is unknown, it can be assumed to be high. A dollar of government expenditure financed by taxation is not equivalent to a dollar of private expenditure forgone.

The cost to the community of each additional dollar of tax revenue raised can generally be expected to increase. At the same time, the benefit from each additional dollar of government expenditure can be expected to decline. Unless marginal government expenditure programmes yield benefits at least equal to the marginal cost of the tax required, community welfare will be reduced. The rising cost of additional tax revenue, which includes the cost of tax avoidance and evasion, limits the tax burden which can reasonably be placed on the community. This reinforces the need to examine thoroughly the quality of government expenditure programmes. It also highlights the point that the lower the revenue requirement, the lower the economic cost imposed on the community through the tax system. Any given revenue requirement should be raised at the lowest possible cost.

A broad and interrelated strategy to address the above problems, while meeting the likely revenue requirement over the next few years, is as follows:

i to continue to broaden the income tax base by eliminating concessions which cannot be justified and by correcting deficiencies in present tax law and practice which lead to an erosion of the base;

ii in due course, to place greater reliance on indirect tax. This would require an increase in the rate of GST, while maintaining the base and a uniform rate;

iii to lower, and to narrow the disparities in, personal marginal rates of tax, and to reduce the rate of company tax, consistent with international tax considerations;

iv to phase out selective indirect taxes, except those that can be justified by social cost arguments; and

v to strengthen the operation of the tax system.

This strategy would provide the following benefits:

i it would encourage personal endeavour and would reduce the extent to which the tax system biases individual and business behaviour;

ii it would complement other policies aimed at achieving a better use of resources from the community's viewpoint and would contribute to the achievement of higher incomes; and

iii it would substantially reduce the incentive to evade and avoid taxes.

Important specific policy areas which would form part of the strategy are discussed below.

Business Taxation

The guiding principles for future business tax reforms should be:

i to tax business income on a more neutral basis thereby evening up effective rates of tax. There should be a progressive move toward a pure nominal income tax base. Such a base is attainable. The more desirable alternative of a real income tax base is unlikely to be practicable in the near term. Further, some of the benefits of an expenditure tax base (as discussed in 1784 Post-Election Briefing) could be best achieved by altering the balance between the income and consumption bases, rather than by attempting to tax all businesses solely on that basis; and

ii to tax income earned through different organisational forms (for example partnerships, companies and trusts), as far as practicable, at the rates of tax applicable to the owners of the capital.

Tax avoidance is recognised as a major problem in this area of the tax system because it erodes the tax base and means that higher and more variable rates of taxation are required to raise a given amount of revenue. This creates distortions and apparent inequities as certain activities and individuals are taxed more heavily than others in otherwise similar circumstances. The effects of tax avoidance can be just as harmful as those of tax evasion.

Difficulties arise in applying an income tax to businesses. Much current work is focused on this area because substantial improvements can and should be made.

International Income

General Principles Deficiencies in New Zealand's taxation of international income and expenditure are a major concern and addressing them is a key priority. The principles on which the reforms should be based are set out below.

Taxation on income flowing across New Zealand's borders should be compatible with the country's overall economic objectives. This means, for example, that the regime should reflect the principle of national welfare embodied in domestic economic policies. Thus, the international tax regime should complement the domestic tax system and harness the maximum benefit for New Zealand from foreign investment by New Zealand residents (outward foreign investment) and by residents of other countries (inward foreign investment).

With respect to investment by residents, the national benefit from domestic investment is generally indicated by the pre-tax return, whereas the benefit from outward foreign investment is the return after foreign tax but before New Zealand tax. For a domestic project, the pre-tax rather than the after-tax rate of return generally indicates its national worth as taxes are a transfer between residents and not a real resource cost. For a foreign project, however, the corresponding benchmark is the rate of return after deducting foreign taxes, as taxes paid to foreign governments are a claim on national resources and hence a real resource cost. National welfare principles suggest that New Zealand residents should ideally be indifferent between investing at home or abroad when the pre-tax return in New Zealand equals the return abroad after foreign taxes but before New Zealand tax. In other words, residents would make the same choices as they would if there were no New Zealand tax. Investment decisions would be unaffected by New Zealand tax and the relative return to the investor and to the nation would be the same.

New Zealand's current practices, which conform with international conventions, are inconsistent with the national welfare ideal. The usual practice is to credit foreign taxes on income earned aboard against residents' domestic tax on that foreign income. This practice leads to a bias in favour of outward foreign investment which may not best serve New Zealand's welfare, even though in return there may be 'excess' inward foreign investment.

With respect to inward foreign investment, the same inrernational conventions recognise that New Zealand has the first right to tax New Zealand-source income earned by non-residents. New Zealand taxes paid by non-residents are-in accordance with the above-mentioned principle-normally credited against taxes payable in their own country. The consequence of these rules is that New Zealand can levy tax up to the amount of tax payable in the foreign country of residence in respect of New Zealand-source income without influencing foreign investors' decisions to invest in New Zealand. In this way, taxes levied on foreign investors can be non-distorting.

Role of Domestic Company Tax Company tax has been the main instrument for taxing income earned by shareholders through companies. Once the imputation system of taxing companies and their shareholders is implemented (see following), the personal tax system will largely fulfil this role with respect to domestic investors. A key role of company tax will then be to levy tax on income earned by non-resident investors in New Zealand companies (and, to a lesser extent, all investors in tax-exempt companies). Thus, in future the rate of company tax will need to be set having greater regard to its impact on inward foreign investment, rather than to domestic considerations as has hitherto been the case.

International Tax Avoidance Measures to combat tax avoidance are a priority in the international tax area. Residents are able to manipulate transactions so as to reduce, or avoid altogether, tax they should pay in New Zealand. A common tax -avoidance technique is for residents, particularly companies, to establish non-resident corporations under their control in tax havens. Income is diverted to these entities by making payments to them for interest, lease and management costs which are tax-deductible in New Zealand. Alternatively, income-producing assets -such as shares, debentures, plant, machinery and rights to income-may be transferred to these entities. The income can be accumulated offshore or repatriated to New Zealand in a non-taxable form such as inter-corporate dividends, loans or capital gains.

An objective of the tax system is to minimise the impact of the tax system on business and personal decisions. At present, however, the system falls short of this ideal and international (and domestic) tax avoidance by businesses has become more aggressive and widespread in recent years. Many activities and transactions are structured primarily to reduce or avoid tax. This is possible because of weaknesses and loopholes in the tax law and deficiencies in its administration. These are compounded by the fact that the probability of avoidance activity being uncovered is low and penalties are limited. While moves to lower tax rates and to remedy deficiencies in the Income Tax Act are the best means of attacking avoidance arrangements, improved operation of the tax system-as discussed following—could also assist.

The introduction of anti-tax haven measures, as announced in the 1987 Budget, will help tackle these and related problems. The aim will, in effect, be to treat certain income earned through tax haven companies on a similar basis to income earned in New Zealand. The preparation of a consultative document setting out the details of the anti-tax haven measures is well underway and should be available by the end of September.

Further initiatives aimed at bringing more international income within New Zealand's tax net are required to better protect and broaden the domestic tax base. Their implementation is, however, impeded by New Zealand's double tax agreements and by international conventions. It may therefore be necessary to limit deductions against New Zealand income where foreign-source income cannot be brought within New Zealand's income tax net. These problems are not unique to New Zealand. While there are gains to be made from reform in rhe international tax area, they may inevitably require the sacrifice of some simplicity in compliance and administration.

Relevant provisions in this regard include those concerning outward income flows such as non-resident withholding tax and transfer pricing rules; the allocation of income and expenditure where more than one tax jurisdiction is involved; the method and extent of granting relief from double taxation; other aspects of bilateral arrangements between New Zealand and its tax treaty partners; major concepts in the Income Tax Act 1776 such as the definition of residence; and disclosure, enforcement, penalty and administrative requirements further to those needed for the anti-tax haven measures.

Conclusion The prospect for future tax reform, including sustainably lower and more uniform marginal rates of tax, is dependent at present to a large extent on the ability of international tax provisions to maintain the breadth of New Zealand's income tax base and to preserve the integrity of the tax system. Improvements can be made from a restructuring of existing provisions, though there are no simple solutions.

In the short term, a further strengthening of New Zealand's international tax regime is essential if tax avoidance and the consequent erosion of the tax base is to be arrested. To this end, while the proposed anti-tax haven measures will be important, protection of the tax base will be an ongoing task. Ultimately, however, the greater is the overall tax burden, the greater will be the pressure on international and other tax provisions and the difficulty in keeping them efficient and fair.

In the longer term, efforts should be made to bring New Zealand's international tax provisions closer to the national welfare ideal. The merits of competing policy options to achieve this end will be difficult to assess. International tax conventions and treaty obligations complicate the analysis considerably. However, the overriding concern must be to ensure that New Zealand's tax system adjusts as necessary so that the nation gains the maximum benefit possible from international investment and income flows.

The Treatment of Companies and their Shareholders

In 1785 the Government announced its intention to introduce a full imputation system of company and shareholder taxation in 1988/89. The present classical system, which reflects the legal view of a company as an entity separate from its shareholders, can give rise to the following distortions:

- i companies may be induced to incur more debt than is optimal, with a consequent increase in risk;
- ii companies may be encouraged to retain earnings rather than raise new equity to finance investment. This penalises new and growing firms with insufficient earnings to finance their investment programmes;
- iii individuals on low rates of tax are discouraged from owning shares. This reduces the range of investment and risk-spreading options open to them;
- iv the corporate organisational form is discouraged, with the result that some profitable investment opportunities may be forgone; and
- v to the extent that dividends are capitalised into share prices, corporate takeovers are tax-favoured relative to the acquisition of assets directly.

The objective of the new regime should be to reduce the potential for the above economic costs by taxing corporate income, as far as practicable, at the marginal rates applicable to individual shareholders.

Details of the imputation system are being developed. At this stage, a qualifying dividend account approach is envisaged. Only dividends paid out of income in respect of which company tax has been paid would carry entitlement to imputation credits. Other distributions would normally be fully taxable in the hands of shareholders. This approach provides some scope for limiting tax avoidance and arbitrage opportunities.

It is expected that a draft consultative document setting out proposed details of the imputation system will be available for the Government's consideration before the end of the year. This reform could cost between $2 70 and $3 30 million in 1988/89 prices in its first full year.

Superannuation and Life Insurance

Most superannuation schemes are given considerable income and fringe benefit tax concessions under the existing law. These concessions have the following undesirable economic consequences:

- i they distort the manner in which people save;

ii they provide superannuation funds with a competitive advantage over other financial institutions;

iii they distort investment patterns if superannuation funds have different risk and return preferences from investors who are subject to income tax;

iv they distort remuneration arrangements and impede labour mobility; and

v they provide substantial scope for taxpayers to use superannuation funds to avoid taxes.

The treatment of pension superannuation-the most common form of superannuation-follows expenditure tax (rather than income tax) principles, with both contributions (up to a specified limit) and net investment earnings exempt from tax. The invested sum and the investment earnings are not taxed until paid our in pension form, and then may be taxed on a highly concessionary basis. Other classes of superannuation are subject to differing tax treatment, some of which are penal rather than concessional. Life insurance contracts taken out after the 1984 Budget are taxed on income tax principles but the rate of tax applied to insurance funds is concessional vis-a-vis the average marginal tax rate of most policyholders.

The present tax treatment of various superannuation and life insurance schemes is supported by extensive regulations designed in part to contain the fiscal cost of rhe concessions. We understand that present regulations are being avoided and we doubt whether the existing regime is sustainable given changes in the financial markers which blur distinctions among types of institutions and instruments. An example of avoidance is one-person superannuation schemes which are being marketed to high-income earners and which involve an agent who contrives to be an employer. These schemes provide tax-free savings for the contributor.

The concessions to superannuation and life insurance tend to benefit people on higher incomes, both because they tend to save more than low-income people, and because the value of the tax concessions increases with individuals' effective marginal tax rates. If the Government wished to continue to assist private provision for retirement, superannuation and life insurance concessions would be a poorly targeted and cost-ineffective way of achieving that goal. This is particularly so when considered in conjunction with national superannuation. For these reasons, there are insufficient efficiency or equity grounds to justify the presenr preferential treatment of superannuation and life insurance.

The consistent application of the tax system requires superannuation and life insurance to be treated on an income tax basis. The alternative of treating all savings on an expenditure tax basis would be inconsistent with moves already implemented which aim to treat investment on an income tax basis.

The taxation of superannuation schemes on an income tax basis would require:

i personal contributions to schemes to be non-deductible;

ii employers' contributions to be taxed either directly or indirectly as income of the employees;

iii net investment earnings of the schemes to be taxed at rates as close as practicable to the marginal rates of scheme members; and

iv all emerging benefits to be tax-free.

One of the most difficult issues in changing the tax regime for superannuation and life insurance is the transition from the existing to the new treatment. It is this area which requires further work before final decisions on the shape of tax and regulatory reform should be taken.

Capital Gains and Losses

It is generally accepted in the tax literature that a comprehensive income tax base should include capital gains and losses. These should be taken into account as they accrue and be taxed at rates applicable to other forms of income. The main arguments for this treatment are efficiency ones. The return on some assets, such as financial assets other than superannuation and life insurance, is largely in a form which is taxed under income tax principles. However, the return on other assets, such as land, is largely in a non-taxed form because the change in the value of the asset is not taken into account. This tends to drive the pre-tax rate of return on relatively lightly-taxed assets down until their after-tax return is equated with the after-tax return on highly-taxed assets. The outcome of this process is likely to be greater investment in lightly-taxed assets than if both classes of asset were taxed neutrally.

The overall return to the community from investment, which is broadly measured by the pre-tax rate of return, is reduced by the exemption of capital gains. Moreover, inclusion of nominal capital gains and losses within the income tax base would extend the tax base, thereby allowing some reductions in existing rates of tax.

To the extent that pre-tax rates of return have adjusted for the absence of capital gains from the income tax base, there is no inequity in the present treatment. It can be expected that such returns have adjusted as the existing tax treatment is long-standing. However, incorporation of capital gains and losses within the tax base could be expected to raise new equity concerns as wealth losses would be imposed on holders of those assets most affected.

Despite the theoretical attraction of including capital gains within the income tax base, the major reason for not doing so to date has been the practical difficulty of measuring gains and losses, particularly as they accrue (rather than as they are realised). While not dismissing this problem, it must be acknowledged that the consequences of not including capital gains and losses in income are considerable. The difficulty of adequately taxing returns from investment in land, company shares, and unit trusts, for example, reflects the exclusion of capital gains from the income tax base. Moreover, many avoidance schemes exploit the distinction between current and capital income. This issue had to be addressed in the accrual regime and will also need to be addressed in the reform of the taxation of international income.

In view of the theoretical attractions of extending the income tax base to capital gains, and the practical problems involved, the question should be researched fully. The aim of the research should be to establish whether a regime could be developed which would provide sufficient efficiency improvements to justify its implementation. Work along these lines should be carried out during the next 2-4 years.

Real or Nominal Income

The present income base is sometimes described as nominal income-that is, income unadjusted for the effects of inflation. A nominal income tax is broadly equivalent to a tax on real income plus a tax on wealth (at the rate of inflation multiplied by the tax rate). Either a real or a nominal tax base, if consistently applied, would be neutral with respect to investment in different assets. New Zealand’s present system is a hybrid, reflecting features of both of these bases.

The necessary steps to move the present tax base to a pure *nominal* income tax base are as follows:

- i nominal economic depreciation, that is, the decline in the nominal value of business assets, would be deductible;
- ii nominal gains in the value of stock-in-trade would be taxable and nominal losses deductible;
- iii nominal interest receipts would be taxable and nominal interest payments deductible (as under existing treatment); and
- iv nominal capital gains would be taxable and nominal capital losses deductible on an accrual basis (as discussed above).

To move to a pure *real* income tax base would require the following:

- i true economic depreciation, that is, the decline in the real market value of business assets, would be deductible;
- ii real gains in the value of stock-in-trade would be taxable and real losses deductible;
- iii real interest receipts would be taxable and real interest payments deductible; and
- iv real capital gains would be taxable and real capital losses deductible on an accrual basis.

From an economic perspective, a real basis for income tax is the preferred option. Inflation-indexing depreciation allowances and inventories would add to the complexity of the system somewhat, but appears to be feasible. Overseas experience suggests that taxation of only the real component of interest payments may be an intractable problem, particularly on a transaction-by-transaction basis. Until this problem can be solved satisfactorily, the real tax base is not a viable option. In the meantime, further moves toward a pure nominal base are desirable. The distortions caused by the interaction of inflation and the income taxes base would be reduced by the following:

- i general economic policies aimed at achieving price stability;
- ii lower rates of income tax in conjunction with base-broadening activities; and
- iii greater reliance on indirect tax.

The broad strategy outlined in the overview to this chapter incorporates moves in this direction.

Other Deficiencies in Taxing Business Income

There are many aspects of the Income Tax Act which are not working well. The New Zealand Society of Accountants and some tax professionals have called for a complete rewrite of the Act, which has not evolved in pace with changes in business practices. This task would be too ambitious in the foreseeable future and would best be deferred until further major reforms have been put in place. There is scope, however, to review and upgrade elements of the Act to put the treatment of different activities, financing instruments and organisational forms onto a more neutral basis.

Personal Taxation

Evaluation of the October 1986 Changes

Despite the shift in New Zealand's tax structure ushered by the 1 October 1986 reforms, the taxation of personal income remains by far the largest component of total tax revenue. (This is portrayed in Appendix I to this chapter.) Because efficiency and equity gains continue to be available in this area, reform should be ongoing.

The system in place before October 1986 was subject to a number of shortcomings. Chief amongst these were the narrowness of the income base; high and variable effective marginal tax rates (EMTRs); some lack of clarity about the appropriate tax unit; and disparities in the form and delivery of family assistance.

Overall, last year's tax/benefit package made progress in overcoming rhese deficiencies. The dispersion of EMTRs was reduced significantly for marker income earners {leaving aside the guaranteed minimum family income (GMFI) scheme, which affects only a small number of families}. The incroducrion of rhe transitional tax allowance in place of the principal income earner rebate reinforced the individual tax unit and removed a penalty on the second earner in a household. At the same time, measures taken in 1984 and 1985 widened the personal income base by removing some concessions and by taxing fringe benefits and income-tested welfare benefits.

On the other hand, it can be argued the changes to the tax rate structure did not go far enough in reducing the substantial disincentive effects formerly present; that Family Support and GMFI, to the extent that they are delivered through the tax system, continue to confuse the appropriate tax unit and impose higher administrative and compliance costs; that the abatement of Family Support leaves many middle-income families subject to a quite high EMTR (48 percent) over a wide range of income; and that the income base is still far from comprehensive, with the omission of capital gains and favourable treatment of superannuarion and life insurance.

Direction of Further Reform

As indicated earlier, the greatest gains in further reform lie in continuing to broaden the tax base and in seeking a lower and more uniform rate structure. A further flattening of the scale is desirable on efficiency grounds. It is imporranr here to focus on the effective, not the nominal or statutory, scale. (The distribution of and range of these scales is discussed in Appendix II to this chapter.) The effective scale measures the total change in an individual's obligations to, or net assistance received from, the Government as his or her income changes. Where that assistance is targeted and abates against income above a given level, rhe effective rate exceeds the nominal scale. This accentuates the distortion which an income tax causes in investment, savings and production patterns and in choices between, for example, employment effort and leisure, and present and furure consumption. Moreover, it is the effective scale which indicates the true redistributive impact of the tax system. This focus is also important because it is possible to envisage reforms which improve the nominal scale but worsen the effective scale, and vice versa.

The desirability of moving towards a flatter income tax scale reflects a concern that, under the present progressive nominal scale, the bulk of income is earned by individuals on high EMTRs relative to the average tax rate. While the overall average rate is about 2 5 percent, an estimated 2 1 percent of adults and one-third of full-time earners are on a 48 percent EMTR. The costs associated with such a relatively high rate must be set against the ability of the tax system to meet the

Government's redistributive objectives. The traditional arguments for progressive taxes—that welfare gains to low earners outweigh welfare losses incurred by higher earners-typically overlook the adverse consequences of high effective rates.

High rates induce the switching of income to presently untaxed or lightly-taxed forms, other avoidance and evasion activities (availed mostly by high-income earners) and generally put pressure on difficult-to-measure boundaries such as those between private and business expenditure and between capital and current income. Further, the static and dynamic incidence of the tax scale may be quite different. A snapshot of income ignores the pattern of changing income over a taxpayer's life. Average income tends to rise steadily with the age of the taxpayer until rerirement. One effect of a progressive tax rate structure is thus to redistribute from older to younger market income earners. Moreover, gross incomes can be expected to adjust in response to changes in tax rates. It is also important to take account of redistribution via instruments other than the tax system-for example, through the impact of expenditure programmes and regulation of economic activity.

A low initial tax rate (and zero-rate thresholds) advantage most those on incomes above the range over which it applies. (Appendix IV to this chapter presents the estimated distribution of 1987/88 personal income by tax brackets.) In moving towards a flatter tax scale, a case can be made for raising, or at least retaining, the existing bottom nominal rate as well as lowering the middle and top rates. Emipirical studies suggest that second income-earners and part-time workers are more likely to be discouraged by high tax rates than high income-earners. This is often advanced as an argument against raising the bottom marginal rate. The point is valid. On the other hand, the efficiency or output losses arising from the aggregate response of higher-rate taxpayers to a corresponding increase in their marginal tax rate are likely to be greater. The latter argument appears to be compelling.

A more uniform scale would then enhance the efficiency gains discussed previously. The question arises how best to assist low-income groups who might otherwise be hurt in the short run by such a move. This could be done through a rightly targeted transitional rebate-type measure. Higher EMTRs would be inevitable over a defined income range. On the other hand, targeted assistance can potentially minimise the disincentive, labour market and dependency problems associated with alternative forms of compensation, such as universal provision or a guaranteed minimum income approach.

The conventional view is that abatement of income-tested assistance should not be unduly high, given possible 'poverty traps'. However, the lower the abatement rate, the wider the income range and the greater the number of individuals facing higher EMTRs. (The trade-off between the magnitude of the EMTR and the numbers of taxpayers affected by the targeting of assistance is illustrated in Appendix III to this chapter with reference to the present Family Support scheme.) It can instead be argued that relatively rapid abatement will on balance produce a less distortionary outcome. When individuals' incomes rise over time, longer-term decisions will be less affected if a quicker transition out of the abatement range is perceived. The alternative is higher fiscal cost, occasioning a larger deficit or higher tax rates elsewhere. Thus, the conflict between equity and efficiency is more apparent than real.

Indirect Taxation

Goods and Services Tax

The introduction of GST on 1 October 1986 marked arguably the most fundamental reform of New Zealand's tax system. It was accompanied by a 20 percent average reduction in personal tax, changes to the social security benefit system and abolition of the wholesale sales tax and several other indirect taxes.

In terms of standard attributes of a good tax-efficiency, equity and simplicity-GST scores highly. The key characteristics are that a uniform rate of tax is applied to the widest practicable base. These are essential in minimising the efficiency costs of the tax and in preserving its simplicity. This is now widely recognised by the community. Even so, care is required to ensure that the GST base, unlike the wholesales tax base which it replaced, is not eroded over time.

The initial choice between a retail sales tax (RST) and a value-added tax (VAT) such as GST rested on judgments about their respective potential to distort economic activity, administrative and compliance costs, and revenue-raising capacity. Overseas experience suggested that a VAT-type tax was to be preferred on these grounds. The more important point, however, is that having implemented a GST, a change to an alternative collection mechanism could not be justified on economic grounds. Nor could it take priority over more pressing taxation problems.

Excise Duties

Excise duties are currently levied on motor vehicles, petroleum fuels, alcoholic beverages and tobacco products. There is no microeconomic justification for excises on motor vehicles or petroleum fuels. In the former case, this has been accepted and reductions on the rate of duty have been scheduled. The distortions produced by the petroleum fuels excise regime are also significant.

The combination of high levels of assistance to the motor vehicle industry, excises on motor vehicles and fuels, and motor vehicle fees and charges means that the ownership and use of motor vehicles is highly distorted in New Zealand. Preassembled (CBU) and unassembled (CKD) car imports are currently subject to a normal tariff of 5 5 and 27.5 percent respectively. The motor vehicle excise is currently 20 percent and consolidated account taxes on fuels account for 30 percent of the retail price of premium petrol. Lower rates of taxation on these products could be expected to substantially improve resource allocation and should be implemented as the Government's fiscal position permits.

A stronger case can be made for selective taxation of alcoholic beverages and tobacco products in order to compensate for the social costs identified with their consumption. However, these costs cannot readily be quantified and even if they could be measured, it is not evident that selective taxation is the most efficient approach to attributing and recovering them from consumers. Further work is required to develop a firm policy which would enable producers co plan with greater certainty.

Stamp Duties

Most taxes create distortions but a tax on transactions, such as stamp duties—which are unrelated to value added or profit--'is particularly distorting. As was indicated in the 1986 Budget, a prima facie case exists for their eventual removal. However, the efficiency losses imposed by stamp duties have to balanced against both the fiscal implications of their removal and competing claims for reform of other taxes.

Customs Duty

This revenue source is not discussed in this chapter. The sole purpose of customs duty is to subsidise domestic producers of import substitutes. Industry policy is dealt with in an earlier section of this chapter.

The Reform Process

The process of tax reform in New Zealand since 1984 has involved widespread consultation prior to the enactment of legislation. Consultation has focused on the implementation of already-announced changes in tax policy, rather than on broad options for reform.

This has facilitated change on an unprecedented scale in a compressed period. It has also been instrumental in gaining a wider consensus than might otherwise have emerged and has been important in improving the proposals prior to the drafting of legislation. Perhaps the main objection is that consultation tended to delay enactment of reforms, some of which were of necessity effective from the date of announcement. The mutual advantages of extended consultation co the Government, taxpayers and tax professionals suggest, nevertheless, an overwhelming case in favour of continuing this approach. It should therefore be followed for substantive programmes now in train-, chat is co say, anti-tax haven avoidance and full imputation- a n d for others which may be considered in the future.

Operation of the Tax System

Improving Voluntary Compliance

New Zealand's tax system, like that of many ocher nations, is based almost entirely on voluntary compliance. Although the system has a number of internal checks and balances, it cannot work properly without the co-operation of taxpayers. The level of such co-operation appears to be falling. Against a background of avoidance and evasion, many well-informed observers believe 'tax morality' co be at a low ebb. If the tax system is to be kept in good health, and is to continue to rest on voluntary compliance, the level of taxpayer co-operation must be restored. The factors that have led to a decline in co-operation must therefore be identified and addressed. Some clearly relate to taxpayer perceptions about tax relativities. For example, a lower level of co-operation is likely where taxpayers believe they are being excessively or unreasonably taxed:

i relative co their perceived view of the returns from the tax revenue. This could be interpreted in many ways. For instance, it might mean that some taxpayers have general perceptions of poor value for money from government services, or that some believe they are not receiving an appropriate share of such services;

ii relative to other taxpayers earning a higher or lower economic income. This is likely where taxpayer views about the appropriate extent of progressivity of taxation, or of explicit income redistribution through the tax system, are markedly different from the intentions of the Government as reflected in various tax provisions;

iii relative to other taxpayers earning the same economic income or in the same economic circumstances. To the extent that the tax system favours particular groups who are able to take advantage of tax-preferred activities, or that the system has weaknesses which can be exploited by particular groups, the tax burden is borne unevenly, leading to perceptions that some are not paying their fair share; and

iv relative to socially accepted norms. Attitudes and practices of given taxpayers are affected by the attitudes and practices of other taxpayers. The general integrity of the tax system has an important influence in this regard. Changes in the factors identified above have probably led to a greater degree of community tolerance of taxpayer behaviour that is borderline and beyond.

Other factors which apparently give rise to a lower level of taxpayer co-operation relate to the opportunities or incentives to escape liability for tax. These will be significant influences where:

i the returns from tax reduction are high. This is typically so where marginal rates of tax are high. With a more competitive climate, the pressure to contain costs has put even more pressure on the tax system. While the tax system has been strengthened, scope for avoidance remains;

ii tax planning in some areas is still relatively straightforward and inexpensive for higher-race taxpayers in particular. The complexity of tax provisions and their inherent flaws, combined with the sophistication and agressiveness of tax planners, smooths the way for much tax-reducing activity; and

iii there is insufficient risk of doubtful tax practices being uncovered and inadequate deterrence in the form of penalties or other provisions. In this context, it can be argued that the tax system significantly favours taxpayers who seek to minimise their liabilities.

Not all taxpayer perceptions are of genuine policy concern and not all tax planning opportunities can ever be closed off. However, there remains considerable scope to improve taxpayer co-operation.

The gains from lower and less disparate marginal tax races will encourage greater co-operation and reduce the benefits from non-compliance. This process is also likely to lead to a greater appreciation by taxpayers of the benefits of co-operation and its links with tax reform.

Apart from tax policy reforms themselves, the biggest gain is perhaps co be made from upgrading the operation and administration of the tax system. The administrative structure must be able co keep pace with changing commercial practices and co maintain a clear focus on areas of major concern. It must also be compatible with the maintenance of a healthy mutual respect berween taxpayer and tax collector.

Administration of the Tax System

The successful implementation of tax reform depends both on coherent, soundly-based legislation and on its efficient administration. Good legislation by itself is not sufficient. In recent years, the Inland Revenue Department (IRD) has been called on to administer several major new pieces of income tax legislation, relating to the fringe benefit tax, surcharge on national superannuitants' other income, primary sector tax, Family Support, and the accrual rules for income and expenditure. These tasks have been placed on the Department at the same time as it has had responsibility for the implementation of GST. Moreover, it will need co implement and administer the measures proposed in the 1987 Budget to combat international tax avoidance, as well as imputation.

These tasks have considerably stretched IRD's resources. It has also lost many experienced accountants and lawyers to the private sector. Given the public sector constraints under which the Department operates, it is not surprising that it cannot compete with the private sector for personnel. However, if Inland Revenue is to successfully administer the income tax system and cope with further reforms, it must be given the ability to recruit and retain the necessary staff. The problem needs to be addressed in the context of public sector management reforms discussed in Chapter 2 of this document.

Some private sector tax professionals have argued that the Government should adopt a more aggressive stance in operating the tax system. They argue chat investigations lean too much towards small businesses and the self-employed rather than larger businesses; that more information should be disclosed by larger businesses to help identify fruitful areas for investigation; and that important cases should be quickly brought before the courts. They also argue that tax policy should be more closely linked to the outcome of investigations.

It is clear that voluntary compliance needs to backed up by a higher expected cost from failure to comply. This centres on both the risks of non-compliance being discovered and on the penalties that result. The views reported above deserve serious consideration in this context.

Conclusion

Taxes impose economic costs on the community in excess of the revenue raised. These costs can be expected to increase with the level of government expenditure. Moreover, they are significant for countries which have similar expenditure and taxation patterns to those of New Zealand. This reinforces the need for government expenditure programmes to be carefully evaluated to ensure that the benefits of marginal programmes are at least equal to the costs of financing them. For a given level of expenditure, the objective of the tax system is to raise revenue at lowest possible cost.

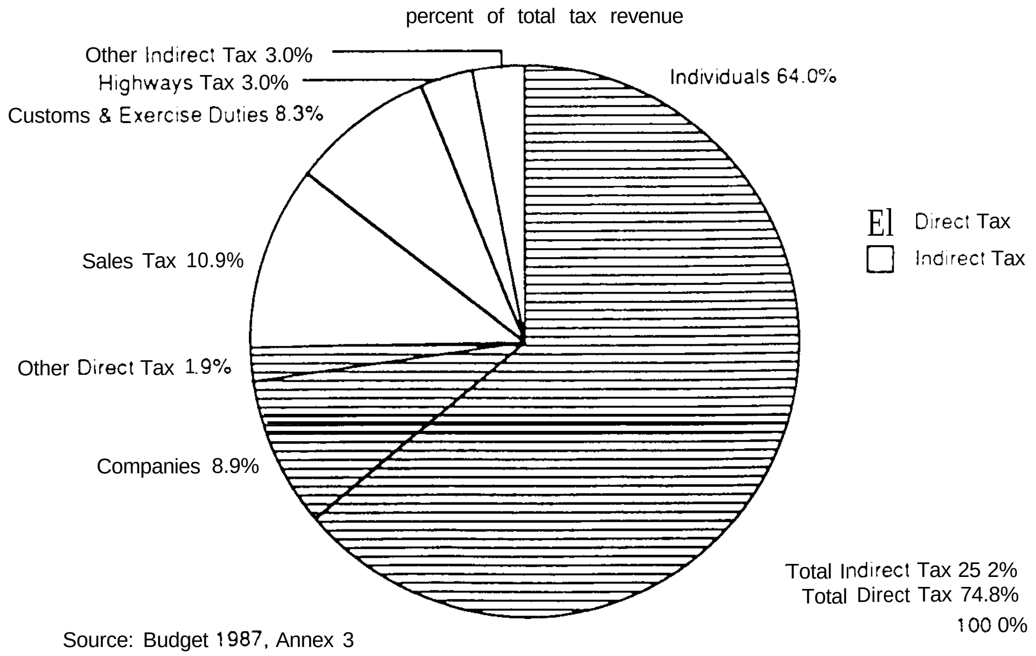
The discussion in this section indicates the substantial scope for further improvements to be made to the tax system. Although there are many specific problems which need to be addressed, the big issues relate to the breadth of tax bases and the rates of tax. The strategy outlined at the outset is based on the simple proposition that, for a given financing requirement, the broadest practicable bases combined with low and relatively uniform races of tax -offer the best opportunity for minimising the efficiency cost of the tax system and for improving equity outcomes.

There are now two major tax bases--'income and expenditure-which provide the capacity to fund government expenditure. The programme of expanding the income tax base should be continued. The remaining deficiencies in income tax law and in the operation of the tax system should be addressed over time. These moves will permit lower and more uniform marginal rates of income tax to be introduced. An increase in the rate of GST would permit additional progress co be made in improving the income tax rate structure, as well as reducing the disincentive to saving and investment and the adverse influence of inflation on the income tax system.

APPENDIX I

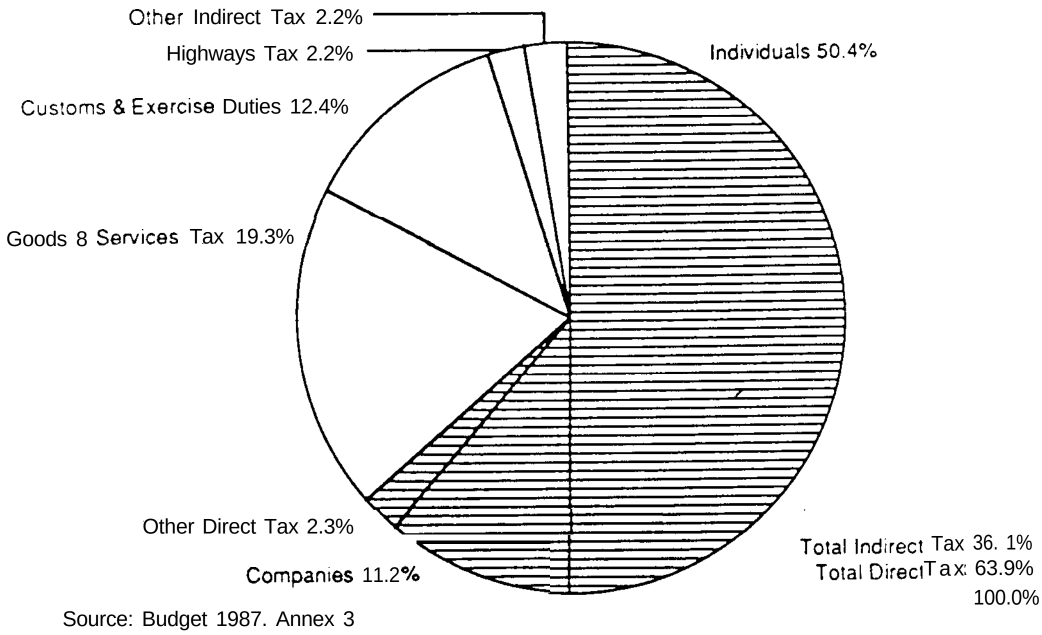
Change in Composition of Tax Receipts

GRAPH Al.l: 1985/86 Outturn



Source: Budget 1987, Annes 3

GRAPH Al .2: 1987/88 Forecast



Source: Budget 1987, Annes 3

APPENDIX II

Marginal Tax Rates—Nominal and Effective

Graph Al. 1 shows the estimated proportions of adults facing different marginal tax rates (MTRs) in 1987/88. The graph was prepared using data from the Household Expenditure and Income Survey for 1985/86.[1] The first ser of bars (dotted) show the distribution of adults according to their *nominal* MTR. Thus, approximately 40 percent of all people aged over 15 are in the first tax bracket with a nominal MTR of 15 percent and total taxable income of up to $9,500. This group includes people with no taxable income. Nearly half of the adult population is in the middle tax (30 percent) bracket, while the remaining 1 1 percent fall in the top bracket with taxable income in excess of $30,000 and face a nominal MTR of 48 percent.

The second set of bars (striped) relate to *effective* MTRs which take account of both the nominal tax scale and the abatement of Family Support, the GMFI scheme and the transitional tax allowance (TTA). These factors increase the effective MTR of the individuals affected above the level indicated by the nominal scale. These factors cause a migration out of both the 15 percent and 30 percent MTR brackets. For example, a parent with no taxable income will face a nominal MTR of 15 percent, but if her or his spouse earns, say, $20,000 then the family faces Family Support abatement and the non-earner's effective MTR will be 33 percent.[2] The earning spouse has a nominal MTR of 30 percent but an effective MTR of 48 percent. This explains the difference between the dotted and the srriped bars on the 48 percent MTR. The withdrawal of GMFI imposes a 100 percent effective MTR.

The final set of bars (in black) shows the distribution of adults by effective MTR, taking account of the national superannuitants' surcharge as well as family assistance and the TTA. The surcharge increases the effective MTRs of those affected by 18 percentage points. Most commonly this takes them from a nominal

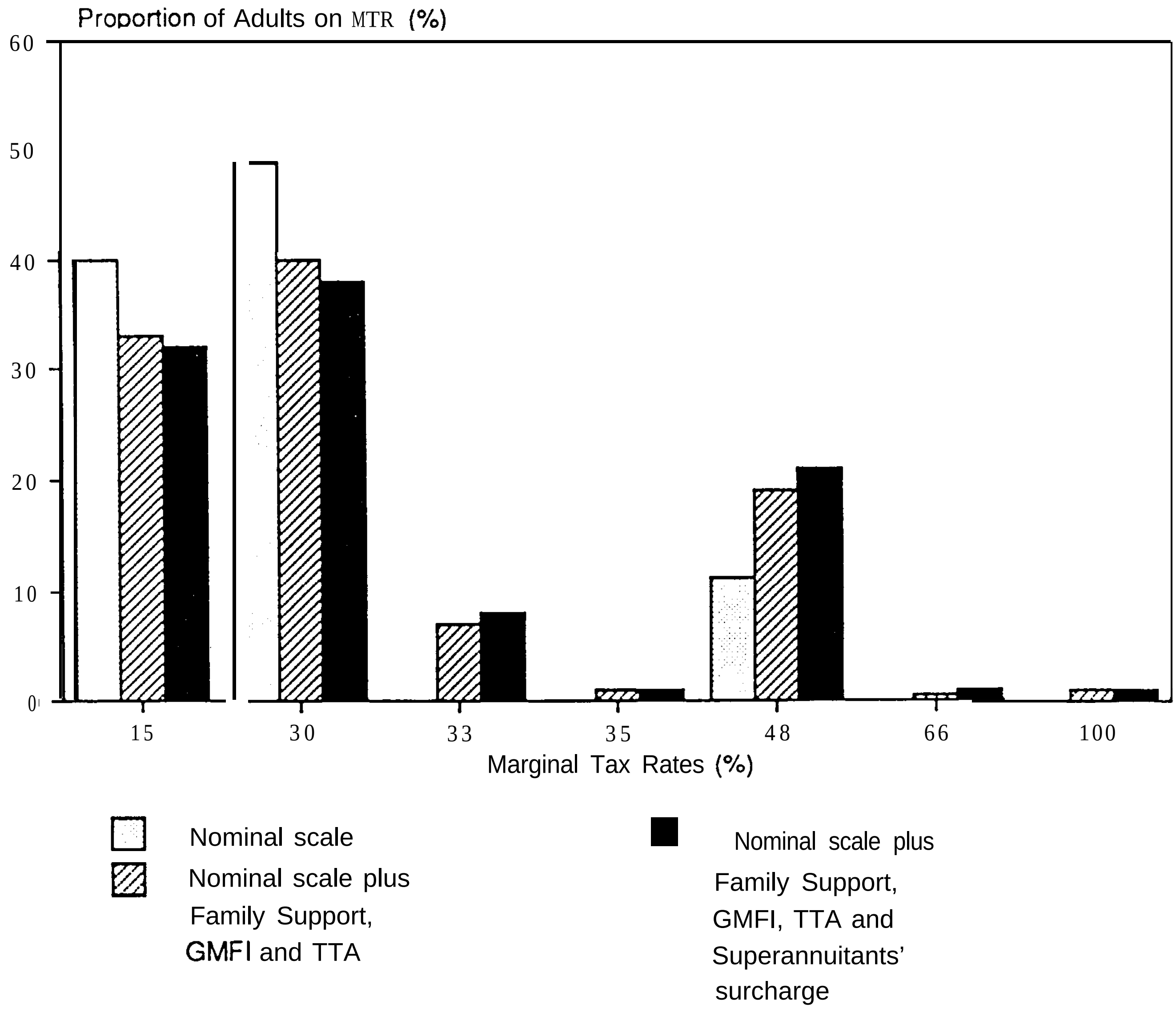
[1] The 1985/86 income data were adjusted using forecast movements in various classes of income (for example wages and salaries, rents, dividends) between 1985/86 and 1987/88. Taxable incomes were then calculated using the present income tax regime, to establish the nominal and effective MTRs of individuals in the sample. All figures used are Treasury estimates.

[2] It may be argued, however, that this is not the relevant race for assessing the effect of the system on the incentive to earn. The 33 percent effective MTR mentioned here relates to the effect at rhe margin on joint after-tax income if the non-earning spouse starts co earn income. However, the effect on individual income is somewhat different. In the case mentioned, the effective MTR in respect of individual income is 24 percent (15 + 18/2). The corresponding effective MTR of the earning spouse is 39 percent (30 + 18/2). Whether the individual or the joint effective MTR is the more relevant depends on the extent co which an individual focuses on his or her own income or that of the parents jointly.

marginal rate of 30 percent to an effective marginal rate of 48 percent. The difference in height between the striped and the solid black bars shows the effect of the surcharge. Clearly, this has a much smaller effect on the distribution of EMTRs than family assistance.

Once all of these factors are taken into account, we see that an estimated 2 1 percent of adults face an EMTR of 48 percent, nearly 39 percent face an EMTR of 30 percent, and about 32 percent face a 15 percent EMTR. The next largest group are those facing an EMTR of 33 percent-about 7 percent of adults.

GRAPH A2.1: Marginal Tax Rates 1987/88
all adults aged 15 +



Source: Household Expenditure and Income Survey 1985/86 adjusted to 1987/88 incomes using Treasury estimates.

APPENDIX III

Family Support—Effect of Changing the Abatement Rate

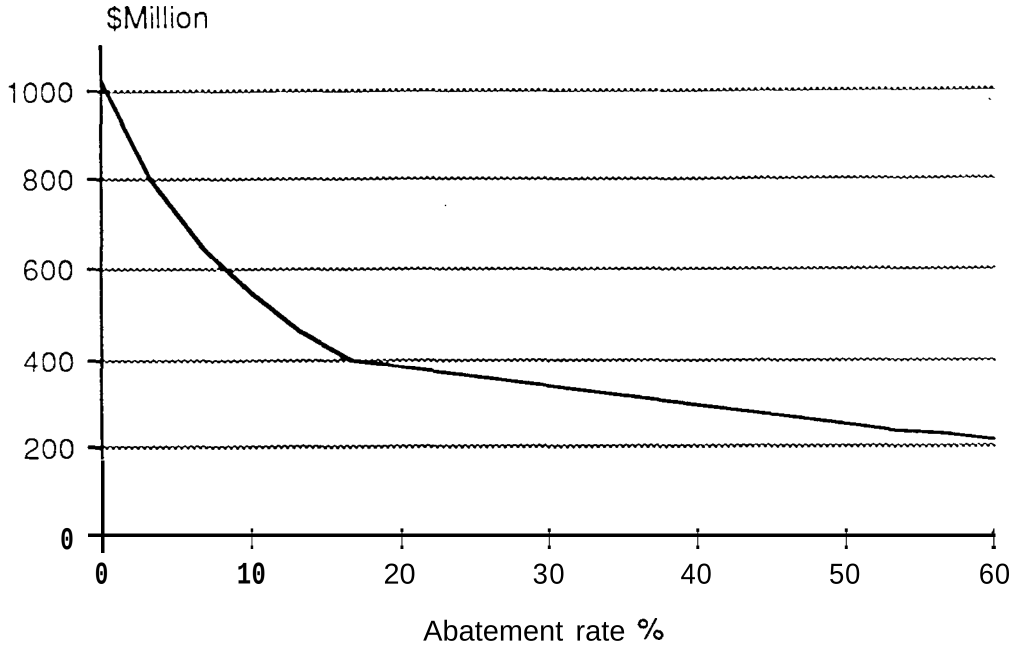
Graphs A3.1, A3.2 and A3.3 illustrate the trade-offs involved in targeting a measure such as Family Support. Along the horizontal axes are alternative rates of abatement of Family Support payments. This is the only parameter that has been allowed to vary. The maximum Family Support amounts ($36 per week for the first child and $16 per week for each additional child), and the joint income level at which abatement begins ($15,000 per year), are kept constant. The graphs were prepared using 1985/86 Household Expenditure and Income Survey (HEIS) data.[1]

Graph A3.1 shows how the cost of Family Support is estimated 'to vary as the abatement rate is increased from 0 percent (that is, no abatement) to 60 percent. For example, at the present abatement rate of 18 percent, Family Support is estimated to cost $400 million in 1987/88. Graph A3.2 shows how the number of families receiving some Family Support drops away as the abatement rate is increased. For example, with the present abatement rate, about 255,000 or 57 percent of families will be eligible for some payment. Finally, Graph A3.3 shows how the number of parents facing higher effective marginal tax rates (EMTRs) as a result of Family Support abatement falls as the abatement rate rises. The EMTR faced by the remaining group of parents is, of course, higher. Under the present system, the EMTR of an estimated 344,000 or about 41 percent of parents is increased by 18 percentage points as a result of the abatement.

The graphs indicate that at higher abatement rates, each of the three variables shown is less responsive (in absolute terms) to a change in the abatement rate. Thus, the higher the initial abatement rate, the more it needs to be increased to achieve a given reduction in cost or in numbers of families or parents facing higher EMTRs.

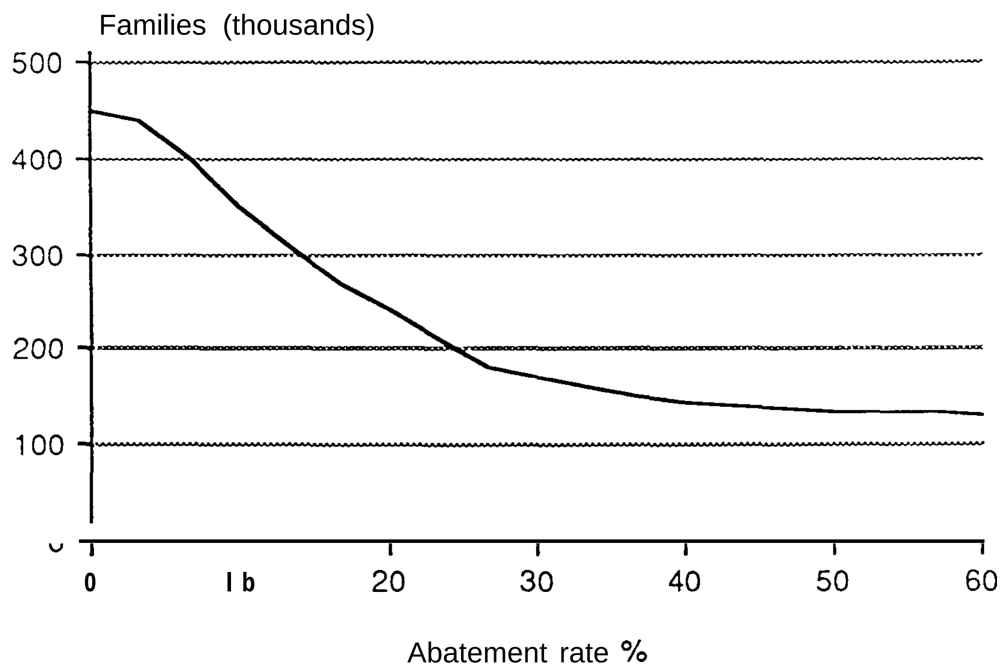
[1] The 1985/86 HEIS income data were adjusted to 1987/88 terms using forecast income movements. The costs of Family Support, numbers of families receiving assistance and parents facing the abatement rate were then estimated for the sample. Finally, the results were adjusted co agree with data from other sources. For example, the maximum number of families eligible for Family Support was taken from Department of Social Welfare data on numbers of families receiving the family benefit.

GRAPH A3.1: Cost of Family Support 1987,438



Sources: Household Expenditure and Income Survey 1985/86 adjusted to 1987/88 incomes using Treasury Esrimares

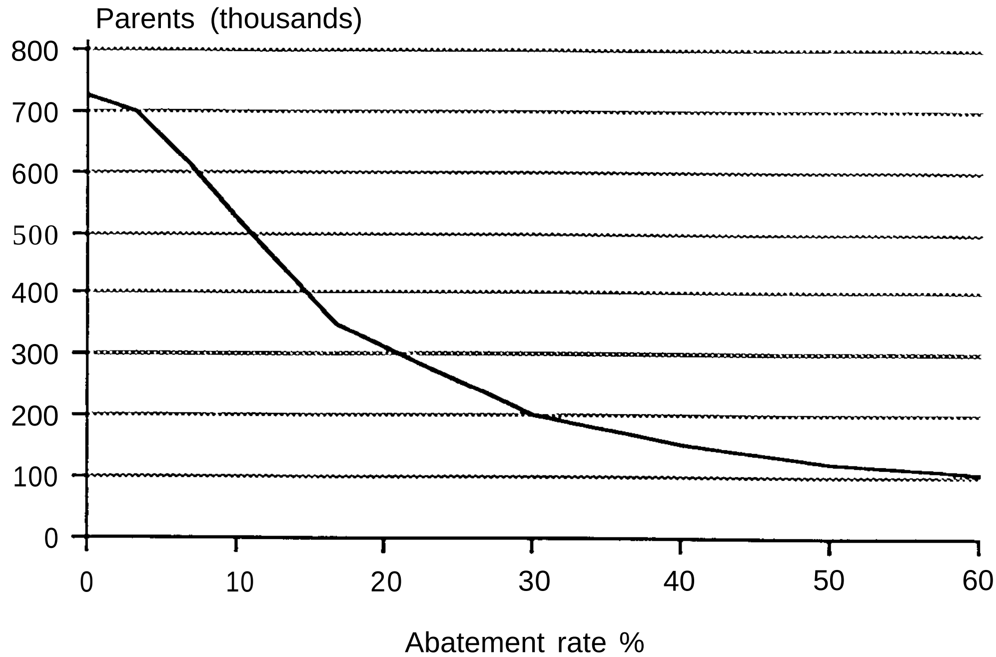
GRAPH A3.2: Families Receiving Family Support 1987/88



Estimated Total Number of Families = 450,100

Sources: Household Expenditure and Income Survey 1985/86 adjusted to 1987/88 incomes using Treasury Estimates

GRAPH A3.3: Parents Facing Family Support Abatement 1987/88



Estimated Total Number of Parents = 829,500

Sources: Household Expenditure and Income Survey 1985/86 adjusted to 1987/88 incomes using Treasury Estimates

APPENDIX IV

TABLE A4. 1: Estimated Personal Income Distribution by Tax Brackets: 1987/88

income tax bracket	*$*	0-9,500	*9,500–30,000*	*30,000+*	*Total*
Nominal marginal tax rate	%	15	30	48	–
Taxable income' within each	$m	18,160	16,470	3,630	38,260
bracket*	%	47.5	43.0	9.5	100.0
	$m	2,724	4,941	1,742	9,407
Revenue raised from each bracket[3]	%	29.0	52.5	18.5	100.0
Taxable income' earned by	$m	4,175	21,940	12,145	38,260
individuals in each bracket[4]	%	10.9	57.4	31.7	100.0
Full-time earners in bracket%	7.9	72.9	19.2	100.0	
Revenue impact of a one percentage-point MTR change'	$m	± 182	± 165	± 36	

'Includes taxable benefit income.

'Shows the aggregate taxable income falling within the indicated tax brackets. Here, the income of a person earning, say, $25,000 would be spread through the bottom and middle brackets (with $9,500 and $ 15,500 in each respectively).

'Total revenue shown here differs from the 1987 Budget forecast of total income tax collections from individuals in 1987/88 for two main reasons:

- i the Budget-night forecast (but not the above data) includes revenue from the surcharge on national superannuitants' other income; and
- ii timing factors relating to the payment of provisional and terminal tax.

'Shows the aggregate taxable income of all individuals with total incomes falling in the relevant tax bracket. Here, the *entire* income of a person earning $25,000 would be included in the middle bracket. Thus, these figures show the aggregate quantity of income facing the indicated marginal tax rate.

'Represents estimates of changes in tax liabilities, rhat is, tax *assessed*, that would arise if rhe nominal marginal tax rates were altered for the whole of 1987/88. The change in tax *collections* for that year would be somewhat different. The estimates illustrate the direct revenue impact and are valid only for relatively small rate changes.

Source: Budget 1987, Annex 3