The Heritage Lectures

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New Zealand: A Blueprint for Economic Reform

By His Excellency John Wood

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I had hoped to talk to you this afternoon about the America's Cup. But my staff have told me that I've done that subject to death, that Americans don't really want to hear any more about New Zealand winning yachting's greatest prize, and that I might actually get a better reception at The Heritage Foundation for one of my other favorite topics—farming without subsidies.

Actually, today I'd like to talk to you about the economic transformation of New Zealand that has occurred over the last decade.

New Zealand at the time of the Korean War was among the five wealthiest countries in the world. By the late '70s, we had fallen to near 20th. New Zealand had one of the poorest performing economies of the Western world; had not dealt well with the oil shocks; had high tariff and other import barriers, high levels of farm subsidies, a national debt that was approaching Third World proportions, a top tax rate of 66 percent; a gold-plated welfare system that the country could no longer afford. From 1975 to 1983, the economy barely grew; the only thing that grew was unemployment—from 0 percent to 5 percent.

In other words, we were as tightly regulated, protected, and centralized as any East European country, and performing about as well. If we'd been a company, we would have been bankrupt, or at the least operating under Chapter 11!

In 1984 a period of reform started which has been described by the OECD as the most comprehensive undertaken by any Western country in recent decades. I've said a little bit about how we got into the mess. How did we get out of it? What are the results today?

PRECONDITIONS FOR REFORM

There were three critical preconditions for reform:

❶ First, in 1984 there was an acute sense of crisis in the country at large.

❷ Second, there was a consensus among New Zealand's professional leadership, both public and private sector, that drastic and comprehensive change was necessary, that no single interest group should be immune from change or should be permitted to dictate the agenda. An intellectual basis for change was provided by a key group of officials in the Treasury, drawing in part on their exposure to academic debate in the United States. A change of government in 1984 brought to power a Labor government that was a generation younger than its predecessor, of liberal persuasion and professional background, and willing to embrace change. They took the view that ideas, productive energies, and confidence for New Zealand to make its way in the world would only emerge from opening all sectors of the economy to the forces of competition.

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❸ Third, there was a realization that no one else was going to help us. There was no fairy godmother out there willing and able to shore up our currency, extend our debt raising capacity, or anything else. We were in trouble, in part of our own making. We had to get out of it ourselves.

WHAT EXACTLY HAPPENED?

Financial Sector

The foreign exchange crisis at the time of the change of government led to a decision to massively devalue the currency, then free float the exchange rate, and then to comprehensively deregulate the financial sector. With foreign exchange controls lifted, new banks were allowed to operate.

Agriculture

Let me spend a little time here even though I appreciate that I may be speaking to the converted, given the position that has been taken in The Heritage Foundation's publications. But let me explain how we got rid of the sacred cows—not the other ones, but the sacred ones.

Farm production and processing account for nearly 12 percent of New Zealand's GDP. Two-thirds of total farm output is exported, earning 60 percent of total export revenue. Agriculture is too big to be carried by the rest of the economy. Assistance to New Zealand's farmers peaked in 1984, contributing to 30 percent of total agricultural output. That was unsustainable. One year later, almost all subsidies were gone, and the rest went soon after.

There are now no subsidies and no other forms of assistance except for spending on inspection, quarantine, research, and pest control. New Zealand's farmers are fully exposed to market forces. New Zealand's agricultural sector is by far the least assisted in the OECD. Government support to farming fell from a peak of 30 percent in 1984 to 3 percent in 1990.

It was not a painless process. Market land values fell by 22 percent during 1982-1988 (indicating the extent to which government support for agriculture was capitalized into farm land values). Overseas markets worsened in the late 1980s, mostly due to the subsidized overproduction of pastoral products in OECD countries.

Nonetheless, the main farmers organization supported the reforms (provided they were implemented throughout the economy, thus lowering farmers' costs of production). Farmers adjusted rapidly to liberalization. Very few were forced out—only about 800, or 1 percent. Farming contracted at the margins (marginal land use, excessive debt loads, and/or incompetence), not across the board. Lurid depictions of rural collapse never became a reality.

Now farmers' real net incomes have returned to the level prevailing in the early 1980s. Farmers have become more innovative and more responsive to markets and allocate their resources more efficiently. They have developed new markets.

Some in the U.S. have suggested that there was a drop in agricultural output. That is misleading. The pattern of farm output changed, reflecting more efficient allocation of resources. For example, there was a trend away from traditional pastoral farming, where most subsidies were once directed (sheep numbers fell from 70 million in 1982 to 50 million today) into a range of areas such as horticulture, forestry, and cattle.

No New Zealand farmers are calling for a return to the bad old days of government support. New Zealand farmers earn their living by their own efforts, without interference. That independence is now fiercely defended by rural people. New Zealand's experience shows that it is possible for farmers to live well and prosper following the loss of government assistance despite the agricultural support policies of other countries, including the U.S., which distort and limit international trade.

Trade

Tariffs in New Zealand were reduced to one-third of what they had previously been. New Zealand consciously opened up its market to imports and international competition. Even after the conclusion of the Uruguay Round, New Zealand unilaterally announced a further round of tariff reductions up to the year 2000 in areas as sensitive as textiles, clothing, and footwear. Over 90 percent of all imports now enter New Zealand free of any quota, duty, or other restriction. In the meantime, New Zealand's manufacturing base has flourished. Our total exports of all goods increased 5 percent in 1994; manufactured goods increased by 7 percent. I know this kind of action is commonly referred to as unilateral disarmament in this country. We simply don't see it that way. We weren't seeking to convey unrequited benefits to anyone else, but to do ourselves a favor.

Market Reforms

The public sector in New Zealand used to run everything from the railways to electricity generation, the telecommunications sector, a savings bank, the coal mines. The government used to build all the roads and dams. Some estimates suggest that the government was involved in 60 percent of the economy, certainly in almost all major investment decisions.

In 1984, the government adopted the principle that the state should not be involved in any activities that could be more efficiently and effectively run by the private sector. The first step was corporatization through the State Owned Enterprises Act of 1986, which involved getting enterprises run on a commercial basis, freeing them from government red tape, putting a private sector board in charge, removing political interference, requiring them to make a profit. This often meant setting clear, unambiguous goals. For example, the Forest Service was never sure whether its main purpose was to plant and harvest trees profitably or to provide jobs. Corporatization removed that conflict.

The second step was privatization, or selling the enterprise and removing the government as an owner. An important principle that was at the heart of the privatization process was minimum regulation but maximum competition. There was no desire to substitute private sector monopoly for government monopoly. The government therefore sought to put in place a framework that would generate competition.

One of the best examples is in the field of telecommunications, with corporatization in 1987 and privatization in 1990. The proceeds of NZ$4.250 billion were used to retire the debt. Telecom New Zealand had 26,500 employees; it now has 9,300. There is competition from MCI on long distance, from Bell South on cellular. Capital investment of nearly NZ$5 billion since 1987 was not paid by the taxpayers. In addition, Telecom New Zealand paid $463 million in taxes in the last three years. From antiquated technology to a 97 percent digital system rated second in the World Competitiveness Report (an independent Swiss-based organization) for telecom systems, and from being a drain on the taxpayer, our telecommunications system has become a significant force in an expanding economy that actually contributes to government revenue through taxation.

The Coal Corporation had had losses in 20 of the previous 22 years. In its first year of corporatization, it increased its level of production while cutting staff numbers in half. And it made a profit. Now while there are fewer workers, they are better paid—and they have a future.

Since 1987 21 former State Owned Enterprises (SOEs) have been sold, generating NZ$12.8 billion, which has been used to repay debt. Some SOEs remain, some possibly to be privatized (for example, Forestcorp). Others may not (for example, Airways Corp, responsible for air safety, with a profit of NZ$6 million last year, or the New Zealand Post, with very large profits, improved services, and a basic postage stamp rate that has not increased in many years).

Public Sector Reform

One statistic that gives an idea of the scale of change in the public sector is that it decreased in size from 88,000 people employed in public service in 1984 to 36,000 ten years later: a reduction of 59 percent.

How did we do it? We made managers fully accountable. For example, permanent heads became CEOs on five-year contracts. They contracted with Ministers to provide certain outputs. We freed up central controls on finance and personnel policies. We let managers set pay and conditions and use capital to the best advantage. Departments can buy and sell assets within their existing level of appropriation without any further appropriation or authority.

We introduced accrual accounting (it was a bit of a shock to find the government's net worth in FY 1992/93 was negative NZ$7.7 billion). We are the only Western government to produce its national accounts in this way, which gives a clear idea of the unfunded liabilities of the government. A capital charge on each department's capital has meant departments no longer regard capital as a free good and leads to much more sensible use of assets, akin to the way a private company would behave.

In sum, three key aspects of the government reforms have been very successful:

❶ Transparency in the activities and processes of the government;

❷ The liberation of managers from central input controls;

❸ The new financial management and accounting systems.

LOCKING IN THE REFORMS

The reform process took place under two different governments in New Zealand. From 1984-1990, there was a Labor government; from 1990 onwards, a National government. The National government took up the reform process from Labor and reformed the Labor market. The Employment Contracts Act provided for comprehensive deregulation, employees not being required to join any union, and few external legal constraints other than contract law and minimum standards. National also reformed the welfare system. It reduced the value of government benefits and targeted them more precisely, including means testing to ensure assistance was directed to those most in need.

Both parties took steps to ensure that in the future, economic management would be as divorced from politics as possible.

- ✓ The Reserve Bank Act 1989 enhanced the independence of the Reserve Bank and stipulated that the bank's main function, for which the Governor would be held personally responsible, was maintenance of price stability within 0-2 percent.
- ✓ The Fiscal Responsibility Act of 1994 requires all of the government's financial reporting to be in accordance with generally accepted accounting practice. The government is required to set medium term objectives, which at present are reducing net debt to between 20 percent-30 percent of GDP, restoring the government's net worth to positive levels, reducing government expenditure to below 30 percent of GDP, not increasing the rate of income tax, and prudently managing risks facing the government. Under the Fiscal Responsibility Act, the government must publish a comprehensive set of accounts annually and before any election.

RESULTS OF TEN YEARS OF REFORM

In 1994 New Zealand was ranked ninth overall amongst the OECD in the World Competitiveness Report. It ranked first in the world for government policy designed to develop a competitive business environment.

After years of low to mediocre growth, New Zealand's economy has grown over the last two years by 5 percent, with growth at times exceeding 6 percent. We believe this is on a sustainable basis. Our mid-term expectation is for between 3.5 percent and 5 percent growth. Inflation has been held below 2 percent—the second-lowest rate in the OECD.

For two years running, the government has balanced its budget. In 1984 the deficit was 9 percent of GDP. This year we expect the surplus will be over 4 percent of GDP (NZ$2.6 billion), rising to 7.5 percent by 1997. Public debt as a share of GDP was nearly 52 percent of GDP at 30 June 1992, is currently 38 percent, and is projected to be down to 18 percent by 1998. Net foreign currency debt will be totally paid off by 30 June 1997.

Government spending as a percentage of GDP—41 percent in 1991—is 34 percent this year, and we aim to have it below 30 percent. Despite this reduction in government spending as a percentage of GDP, expenditure on education overall has been increasing steadily. It was the top expenditure priority in the budget just recently announced. It is now over 5 percent of GDP, above that in the U.K., Australia, and the United States.

When accrual accounting was introduced, we discovered the government's net worth in 1992/93 was negative $7.7 billion. By next financial year we expect it to be positive. Unemployment has fallen from a high of 10.9 percent to 6.6 percent, with excellent employment growth in last two years.

But even more than these economic statistics, the process of reform, which has not been without pain for many New Zealanders, has now led to a new spirit of self-confidence in the country and a feeling that New Zealand has positioned itself to compete in the global environment. We are now free traders *par excellence*. We have the cleanest and most comprehensive free trade area in the world, with Australia. We are talking to Chileans. We are exploring a link between the Australia/New Zealand Free Trade Area and ASEAN. We would be delighted to talk free trade with any other economies in the Asia/Pacific region.

I hope you will all come down to New Zealand to see for yourselves. New Zealand is not just a pretty place to visit, but also a very stimulating environment. Whilst we do not pretend that there are necessarily any lessons from what has happened in New Zealand for other countries, we are always happy to share experiences with our friends. Come down and see us defend the America's Cup!