Chapter Eleven

Labour and Employment

Background

The high levels of unemployment of recent years contrast markedly with the experience of the 1950s and 1960s. During that period registered unemployed typically did not exceed 1000 (annual average basis) and census unemployed numbered around 7000 to 9000, or approximately 1 percent of the labour force. Even when higher non-seasonal unemployment did occur in the 1967/68 and 1971 recessions this was more or less reversed by subsequent upswings in activity resulting from either external events or engineered by domestic policy stimulation. By and large, low levels of unemployment were sustained in the face of a growing labour supply because of favourable terms of trade and income expectations which were in line with the economy's actual growth performance. By OECD standards our rate of growth of output was poor, although employment growth was above average.

Since the mid 1970s unemployment has risen sharply with registered unemployed reaching 76,475 (annual average basis) for the year ended December 1983. In recent months the somewhat artificial pick-up in economic activity and decline in the average structure of real gross wages has been associated with a fall in registered unemployed. The economy is expected to turn down again before Christmas 1984, and it is unlikely that an ongoing decline in unemployment will be sustainable in the medium term with the current configuration of policies.

There is no reason to believe, however, that the present level of unemployment represents an intractable problem. A number of factors support this view. First, through most of the post war period many OECD countries experienced low unemployment rates with only minor deviations over time. Secondly, New Zealand was able to' absorb considerable increases in labour supply during the 1950s and 1960s when annual labour force growth averaged 1.8 and 2.2 percent-well in excess of present and expected growth rates. Thirdly, the unemployment performance of some countries, including Japan, Finland and Austria has been reasonably good over the last decade. Those countries which have performed better on the employment front also tended to perform better on all economic indicators, adjusting more rapidly to changes in the international economic environment which have occurred.

This paper argues that the high levels of unemployment experienced in recent years are a symptom of the more general difficulties the economy has faced. It shows how increased employment opportunities and a better employment performance are closely related to policies designed to improve economic performance in general and the flexibility of adjustment in the labour market in particular. It is also possible to improve the way in which assistance is provided for those people who are disadvantaged in the labour market and who remain unemployed for long periods. The paper combines a review of existing policies and an outline of the direction which the Government is encouraged to take to improve our employment performance.

Unemployment as an Adjustment Problem

The present unemployment problem can most usefully be considered in the context of a labour market adjusting to underlying changes in demand and supply conditions. This is not to deny the complexity and characteristics which are special to this market. The labour force is made up of people of different ages and with different skills, work experience and levels of productivity. The agreements struck in the labour market tend to be based on a longer term view of labour costs and the rewards derived from employment. Nevertheless, as in other markets, willing sellers (of labour services) trade with willing buyers within the prescribed rules governing the nature of trading. These market forces have determined the structure of employment and skills. As the balance of economic activity has changed, labour services have been attracted into expanding activities and released from declining ones, new skills have emerged and the relative rewards to skills altered. Table 1 in the Appendix shows the changing structure of employment across industry sectors.

Given changes in relative market prices for goods and services or in production costs through technological change, some activities become relatively more profitable than others at the prevailing wage structure. In the labour market, adjustment to these changes can occur through changes in the wage structure (occupational, industrial, geographic relativities), and/or changes in the level or pattern of employment.

The movement of labour into emerging activities can be achieved by employees voluntarily taking up opportunities in more profitable new areas of production or, involuntarily, as business owners contract less profitable activities. To some degree, this movement of labour can be reduced by altering wage relativities to sustain the relative profitability of existing product lines. However, because most skills are not specific to particular products or firms, there is a limit to the length of time that skilled employees can be kept in relatively low-paying activities.

The dynamics of unemployment, therefore, are that a large number of new jobs are being opened up all the time in response to changing economic conditions. At the same time many old jobs are being closed down. There will always be a queue of people searching for a new job. Some people would have left their jobs involuntarilv or would have newly entered the labour force. Others would have -intentionally become unemployed prior to obtaining a new job. Such people will have balanced the degree of dissatisfaction they were experiencing in their previous position against the costs and benefits of their probable duration of unemployment. Because people enter and leave the queue at different points they experience varying durations of unemployment. For instance, some people change jobs directly or obtain employment immediately as they enter the labour force. Notwithstanding the relatively high level of unemployment, there is considerable movement through this queue. Several hundred thousand jobs a year turn over in New Zealand and the majority of people who become unemployed are outside the workforce for a relatively short period. The completed duration of unemployment benefits is indicative of completed durations of unemployment. In the twelve months to March 1983, 120,950 unemployment benefits ceased of which 63 percent had been in effect for three months or less.

The level of unemployment at any point in time will depend on the length of this queue and how quickly people are able to move out of it. These factors will clearly be affected by the economy's capacity to generate new employment opportunities and, therefore, its overall growth performance. Sustained economic growth enables a growing labour supply to be absorbed into jobs without shifting an excessive burden of adjustment on to wages alone. At the same time, labour market flexibility in both wages and the movement of labour between skills, occupations or activities will, by facilitating necessary resource shifts, enhance overall growth performance. To the extent that the economy is not able to generate new employment opportunities rapidly enough and there is inadequate labour market flexibility, queues will lengthen and people will move more slowly through them. The economy is then likely to face relatively high levels of unemployment for a prolonged period.

The supply of resources to the economy, the efficiency with which those resources are used, and technological change which increases their productivity, together determine the rate of economic growth. The regulatory and institutional framework surrounding the labour market influences its flexibility and the mechanisms through which changed labour supply and demand conditions are inevitably accommodated.

— *New Zealand's Unemployment Problem*

The oil shocks of the 1970s brought about large relative price shifts which made many existing activities uneconomic, and opened up many new opportunities (e.g. in energy development and non-energy-intensive production). Given limited flexibility in the wage structure in the short run, it was not surprising that the economy went into recession and job queues lengthened. Ordinarily, however, it could be expected that job queues would have shortened again as things settled down and resource shifts into activities which had become relatively profitable under the new price structure were completed.

The persistence and worsening of unemployment has reflected the interaction of poor general economic performance and the limited flexibility of the labour market. The rate of economic growth and general economic performance are influenced by the configuration of macroeconomic policy and measures which directly affect the structure of resource usage in the economy. The adjustment capacity of the labour market is influenced by the institutional and regulatory framework surrounding the market. Any desirable solution to our current unemployment problem requires a reorientation of policies which are currently inhibiting our economic performance and the removal of impediments to a more flexible labour market.

Economic Performance and Employment

The policies which affect our general economic performance are discussed in more detail in other papers. This section focuses on the linkages between these policies and employment performance.

— *Macroeconomic Policies*

Macroeconomic policy settings have contributed to poor growth performance in a number of ways. First, through their effects on relative prices they have slowed the necessary resource shifts. High and persistent fiscal deficits accompanied by substantial external borrowing have enabled New Zealand to maintain a higher structure of wages and prices than would otherwise have occurred. The outcome is an overvalued real exchange rate, impeding resources from moving into export and import competing activities. Wage and price controls designed to alleviate the inflationary consequences of expansionary policies have also affected the ability of the price system to signal new profitable resource uses. Controls on interest rates **are** likely to have restricted the ability of these activities to compete resources away from declining activities.

Secondly, the volatility of monetary and fiscal policies has tended to destabilise activity, adding to uncertainty about expected future policy actions and market conditions. Such uncertainties tend to inhibit planning, investment and employment decisions.

Expansionary demand policies have been pursued in the hope of significant gains in output and employment. However, any benefits appear to be of only a short term nature. The large and persistent fiscal deficits in recent years have been associated with, at best, static unemployment.

In light of the already large fiscal deficit, the output and employment gains arising from further demand support are likely to be negligible in relation to the costs of ongoing inflationary pressure and debt accumulation. Macroeconomic policies directed at creating an environment conducive to sustained economic growth are more likely to lead to improved employment performance. This implies a policy configuration which enables markets to clearly signal and respond to changes in relative prices and which does not unduly increase the uncertainty faced by market agents. In terms of actual initiatives, this translates in to a policy package which includes fiscal restraint, regaining monetary control, freeing up interest rates, and a more market determined exchange rate. A more comprehensive discussion of these elements of policy is set out in other papers.

— *Resource Allocation*

The ability of the economy to create new jobs and to facilitate a more rapid absorption of labour released from declining activities is closely related to the impact of government policies on the efficiency of resource use and overall growth performance. The maintenance of quantitative forms of protection, fiscal assistance to industry, income support for some agricultural producers and subsidised jobs in the public sector have all contributed to an assistance structure which has tended to distort private returns between activities and diverted resources from areas which would provide the greatest gains in national income. In some instances these measures have been intended to compensate for the decline in profitability of import competing and export activities resulting from the overvalued real exchange rate. They have, however, tended to create disparities in assistance among activities in the export and import competing sectors. In other cases they have been seen as fostering employment objectives by protecting existing jobs and creating new ones. To the extent that these policies lock resources into activities yielding low returns relative to alternative activities in which they might be employed, national income and the economy's ability to generate employment opportunities is sacrificed. In this regard, attempting to stimulate employment through undertaking public works which do not satisfy normal investment criteria is likely to slow employment growth over the medium term.

It is sometimes suggested that, by using assistance policies to encourage activities perceived as having substantial growth potential, higher levels of growth and employment might be achieved. Because such information is not likely to be available at a government level, the danger is that this type of policy could lead to resources shifting into areas which subsequently turn out to yield relatively low returns. Moreover, such policies tend to be effected through investment incentives or other forms of subsidy to capital. They therefore not only risk slowing growth but tend to lead to a more capital intensive structure of production than would otherwise occur. Provided returns are not unduly distorted by regulations or other forms of intervention, decentralised market processes founded on the monitoring and performance tests of profits and losses are more likely than a centralised authority to select appropriate investment and production activities.

The appropriate policy direction is rather to move to a lower and more neutral structure of industry assistance. By fostering a more competitive environment and not distorting the relative profitability of activities, this will enable resources to be more rapidly channelled into activities yielding high returns in response to changing market conditions.

Labour Market Adjustment

More stable and predictable macroeconomic policies and the dismantling of existing policies that reduce the efficiency of resource use will together lead to improved overall economic performance. This will reduce the burden of adjustment that must be borne by the labour market. Nevertheless, flexibility in the labour market is critically important to improved employment performance. The level of unemployment ultimately depends on the adjustment capacity of the labour market to clear imbalances between labour supply and demand. In the United States the rapid fall in unemployment over recent months to a level comparable with those of the 1960s has been associated with increased flexibility in both remuneration packages and work practices. This contrasts with the European experience where employment has been much slower to respond to increased economic activity.

— *Wage Flexibility*

a *Wage Response to Market Conditions*

The medium term objective of any reform to the system of wage fixing should be to engender greater flexibility. The wage fixing system that existed before the freeze is inherently rigid. This is indicated by:

— 91 percent of awards in the 1981/82 wage round settling within 1 percent of the core rate of the Metal Trades Award at a time in which rates of unemployment differed markedly across skill groupings;

— a similar density of rate of change in prevailing wage rates (that is rates actually paid) across industries and occupations; and

— little change over time in the relative importance of **non-wage** payments.

Wages are the price for labour, and as with any price they need to be responsive to underlying demand and supply conditions.

Greater flexibility may mean that the real wage for some groups in the labour market will fall, at least in the short run. At the same time, market conditions for a particular skill, occupation or industry may drive up the real wage for other groups. There is no single price for labour. The labour market is a structure of submarkets each relating to a particular skill or occupational group. Because each of these submarkets may at any point in time face unique supply and demand conditions, there is no reason why their respective wages should move at the same rate or even in the same direction. The resulting wage differentials are fundamental to the market processes which allocate the available supply of labour among skills, occupations and activities.

In this regard the practice of providing general wage orders is at odds with the role of wages as the price for labour. General wage orders have no regard for differences in productivity performance and profitability across activities. They also tend to force governments to make a trade-off between inflation and employment objectives. If the general wage order is accommodated by monetary expansion its effect will be to raise prices, and if it is not, the outcome will be a lower level of employment.

Greater flexibility may lead to wage outcomes for some people which are incompatible with the community's objectives in relation to an equitable distribution of incomes and social justice. For example, some individuals may through disability, illness or lifestyle preferences be simply unable to be employed productively at a reasonable wage. These situations are more appropriately dealt with through, the taxation and social welfare systems, rather than by interventions in the labour market which almost inevitably impose job losses on others. Living standards depend on both wages and the incidence of the Government's fiscal activities, that is the "social wage". As discussed in the paper on Fiscal Policy, there is considerable room to improve levels of support to the disadvantaged, through better targetting and programme cost effectiveness, without increasing overall expenditure.

To put a floor under wages, either by a minimum wage law or some concept of a "minimum living wage" in wage negotiations is probably a particularly inequitable form of labour market intervention. It tends to push out of the workforce, or into unattractive low paying jobs not protected by regulations or collective agreements, the very people who, because of a low level of skills and/or disabilities, are least able to protect their interests. In any event it will be the least advantaged members of the workforce who bear the burden of the market adjustments.

Improved wage flexibility involves a system of wage fixing which is able to accommodate industry and even firm-specific conditions, so that firms which want to attract labour by offering higher wages can do so, whereas in firms which cannot avoid redundancies if labour costs rise workers can have the option of forgoing wage increases. This requires allowance for greater flexibility in the laws and regulations influencing wage relativities. In this regard the existing regulations governing union registration have tended to be biased in favour of an occupationally based union structure and have impeded the development of industry or firm based negotiations. The recent tripartite talks on wage fixing have reached agreement on the need for greater flexibility in wage setting and, to some extent, on the methods for promoting that flexibility. There is considerable room for doubt, however, that the proposed reforms will go far enough. In particular, changes to union registration rules have not been considered.

b *Wage Adjustment in the Short Run*

In the present circumstances it is clear that the unemployment problem cannot be addressed by engineering an expansion of demand. This is prohibited by the balance of payments situation at present but, more importantly, past experience has shown that the employment gains arising from such expansions are both uncertain and shortlived. The main effect of deferring the adoption of a more fundamental approach is to aggravate future adjustment problems. To address both the balance of payments problem and the unemployment problem simultaneously requires, at least in the short run, a lowering of the domestic cost structure. This will tend to make it more profitable to increase the labour intensity of production and to promote the expansion of production and employment in export and import competing sectors. The prevailing level of unemployment in conjunction with the level of overseas borrowing is irrefutable evidence that, with the existing productive structure, the average level of real labour costs is too high.

During the process of adjustment, real wages (deflated by producer output prices) must fall relative to labour productivity, for the whole economy. This would involve an expansion in the share of profits in national income. Profits, by providing the incentive and funds for increased investment, lay the foundations for future growth. This process is a prerequisite to increasing employment.

These adjustments can be brought about either by a fall in real labour costs with labour productivity held constant, or by improving labour productivity with real labour costs held constant (or even increasing). Clearly the latter type of adjustment is preferable. It is through increases in labour productivity that higher real incomes and standards of living are attainable.

Increasing labour productivity is not simply a matter of people working harder. It involves resources moving to their most profitable uses, utilising an efficient mix of labour and other inputs and drawing on technological change in the production process, innovation in product markets and flexible work practices. The key to this is policy changes directed to improving overall economic performance.

The potential to improve productivity significantly is unlikely to be realised rapidly, although the gains from regulatory reform may be considerable. Because of this, wage restraint is essential in the short run if unemployment is to be substantially reduced.

c Incomes Policy and Wage Adjustment

The controls on wages put in place in mid 1982 have been associated with some decline in the average level of real gross wages, However, this has been achieved by policies which have imposed other forms of costs on businesses. As pointed out in the paper on macroeconomic policy, the freeze represented an attempt to substitute for appropriate monetary and fiscal policies. This has led to a build up of wage and price pressures in the economy. It is also likely to have involved some costs in terms of overall economic performance in the longer run. In controlling the level of wages and prices, incomes policies prevent changes to relative prices. This tends to impede efficient resource use and thus growth. The burden of adjustment is also shifted to the level and pattern of employment.

Should incomes policies in the form of centrally determined wage adjustments become a permanent feature of the economy, the costs in terms of the misallocation of resources are likely to be substantial. Adopting policies in the short run which are broadly consistent with wage restraint is quite different in its implications from a medium term policy of predetermining the overall rate of increase in money wages, or the rate which should apply in particular markets. The cumulative effect of differentials in productivity performance among activities and the complexity of the labour market and employment contracts means that it is not possible to determine administratively the structure of wages which maximises efficiency.

Rather than adopting formal guidelines for wages and prices, the Government might facilitate wage restraint by a process of consultation with the community. This would enable the Government to communicate its view of the current economic environment, the decision rules on which policy is based and the expected implications for market conditions. This process-an alternative incomes policy-would not impede relative price changes but would provide a more informed basis for market agents to make wage, pricing, investment and employment decisions.

d *The Transition Away from Existing Wage Controls*

While it is clear that the Government should not persist with the current system of controls if it wishes to improve economic performance, consideration will need to be given to an appropriate transition path. It would be undesirable to move away from controls at a time in which there are considerable pent-up inflationary pressures if the Government intends to shortly implement policies to eliminate those pressures. Macroeconomic policies play a critical role in signalling the need for wage restraint. A process of consultation with unions and employers might also play a key role by providing the Government with an opportunity to communicate and gain public acceptance of its macroeconomic policies and the need for adjustment in the labour market. Finally, reforms in line with greater flexibility are required to the wage fixing system.

— *Other Aspects* **of** *Flexibility*

The system of wage fixing is only one aspect of the institutional and regulatory framework surrounding the labour market. Superannuation arrangements, accident compensation, the eligibility conditions for and levels of social welfare benefits, the supply of skill training, regulations governing apprenticeships, safety regulations, occupational licensing and rules for professional bodies are all likely to affect outcomes in the labour market. Although perhaps desirable for other reasons, such institutions, practices, regulations and social programmes can inhibit efficient labour market responses. Possible impediments of this nature should also be investigated to ascertain whether government labour market policies are justified in terms of net benefits.

These other impediments may well affect real wage outcomes; but are also likely to influence the flexibility in the movement of labour among skills, occupations, regions and activities. Some of them relate directly to the “top end” of the market-the professional and skilled occupations. While unemployment is not concentrated in these areas, such impediments may have important consequences for other parts of the labour market. For instance, occupational licensing and the rules governing the professions tend to give these groups a monopoly over a range of work tasks, some of which could reasonably be undertaken by less skilled members of the labour force. Where this occurs, the effect is to enable professional and highly skilled groups to protect their incomes against competition from the less skilled. The higher cost of their services reduces the real income of others. In cases such as this, improved labour market efficiency is likely to be consistent with a more equitable distribution of incomes.

Of particular importance to flexibility in the movement of labour are arrangements for the supply of education and skill training. In its role as a supplier, the Government needs to examine its efficiency in meeting changing skill requirements in the labour market. It needs also to examine regulations governing the supply of these services and the assistance provided to various types of education and training.

The Government also affects labour market flexibility through its activities as an employer. To the extent'that public sector wages are insulated from underlying market conditions, a greater burden of adjustment is forced on the private sector. Recent legislative changes which give greater emphasis to retention and recruitment factors in public sector wage determination should lessen this problem. Inadequate wage flexibility has in the past caused adjustments to occur through the level of employment. There is a need for a wide ranging examination of employment practices in the public sector, in terms of both their effects on labour market flexibility and the efficiency of the public sector.

Helping the Unemployed

A more stable and predictable macroeconomic policy environment and policies to improve the operation of markets throughout the economy should, in the medium term, lead to improved employment performance. The present unemployment problem, while not intractable, will nevertheless not be resolved quickly. In the meantime there is a case for the Government to provide assistance to those members of the community disadvantaged by unemployment. It is important, however, that policies to assist the unemployed do not unduly impede improvements to overall economic performance or labour market flexibility. Achieving a sustained reduction in unemployment would, otherwise, be delayed.

— *The Unemployment Benefit*

The traditional form of assistance provided to the unemployed is an unemployment benefit. Its purpose is to prevent the standard of living of those persons who are unemployed and their dependents falling below some minimum level. At the same time, the level of income support and other associated eligibility conditions are likely to affect adjustment in the labour market. This occurs because of its effects on the incentives to quit existing jobs, to seek and accept new employment (whether it be part-time or full-time work) and to acquire skills. For instance, the higher the level of the benefit relative to wages, the more it may tend to prolong the duration of unemployment and to hinder the acquisition of skills.

— *Labour Market Programmes*

A wide range of labour market programmes subsidising employment in the public and private sectors form a major part of the present policy to deal with unemployment. These work by lowering the cost to employers of labour which would otherwise not have been employed at ruling wage rates. They represent an attempt to switch production technologies and the structure of industry in a more labour intensive direction. At the same time, however, policy interventions in other areas, such as interest rate controls, depreciation allowances and investment incentives, lower the cost of capital and bias labour/capital choices in the opposite direction.

These programmes have also been presented as job or employment creating. They are unlikely, however, to increase significantly the economy-wide level of employment as they tend to displace employment from other activities. This occurs in a number of ways. For example, in some firms, subsidised labour may be substituted for unsubsidised labour which would have been taken on anyway as part of the normal process of labour turnover or ‘company expansion. Growing firms will tend to hire subsidised labour while declining firms shed unsubsidised labour. (It is this mechanism that renders an additionality rule incapable, in the medium term, of preventing the displacement of unsubsidised by subsidised workers.) Firms and public agencies using subsidised labour will produce goods and services which compete with other producers in the field and reduce the latter’s employment opportunities. Finally, even though there may be some positive short term employment response, the expansion of labour market programmes must eventually involve a reduction in other government expenditure, or increased taxation or borrowing from the private sector. Each of these displaces production and employment elsewhere in the economy. Alternatively, if the expansion of programmes is financed by accommodating monetary policies, the resulting domestic inflation will reduce New Zealand’s competitiveness and employment in sectors exposed to international competition.

In a recent Department of Labour study of the Private Sector Additional Jobs Programme, it was found that 65 percent of the subsidised jobs would have been created in the absence of a subsidy. This estimate is based only on first round effects and is therefore likely to overstate overall employment gains. The substantial displacement of employment means that the primary effect of the programmes is to redistribute employment opportunities. Accordingly their function, if any, should be as a transitional measure to assist those people who face serious problems in adjusting to changing labour market conditions.

The majority of people who become unemployed remain outside the work force for a relatively short period, indicating that they are unlikely to be facing serious problems adjusting to labour market conditions. These individuals would normally be picked up by the labour market without government intervention to place them in work programmes. To provide assistance over and above the unemployment benefit is, therefore, unlikely to be cost efficient and may delay a return to lower levels of, unemployment.

In the light of the limited role of labour market programmes and the essential requirement for long term policies aimed at directly removing labour market rigidities, the following criteria for developing programmes would seem appropriate. First, the subsidies should be targetted to those facing serious adjustment problems in the labour market. Unemployment duration would seem to be the most reasonable proxy to identify this group. Secondly, the programmes should be cost efficient in reintegrating these people into the work force. Thirdly, the subsidies should be consistent with flexibility in labour markets and should not inhibit medium and long term policies aimed at removing rigidities.

Against these criteria there is significant scope to improve existing programmes. In some instances the programmes are poorly targetted, the level of subsidy tends to represent a high proportion of the wage, the programmes generally operate within the award structure (which may itself be an important labour market rigidity) and it is unclear as to how successful programme participants are in obtaining unsubsidised work when the subsidy terminates.

Conclusion

The present level of unemployment is one symptom of the more general difficulties that New Zealand is experiencing. It reflects comparatively poor economic performance over a long period and inadequate flexibility in the labour market. To achieve a significant sustained reduction in unemployment requires, on the one hand, improvements to the overall rate of economic growth and, on the other, increased labour market flexibility.

A more stable and predictable macroeconomic policy environment, together with the dismantling of policies which tend to reduce the efficiency of resource use, should facilitate the adjustments required to achieve a higher and more sustainable rate of growth. In the labour market, a programme of study is required to identify the main factors impeding adjustment. It is already apparent that reforms to the wage fixing system are required to enable greater flexibility in wage outcomes.

In the short run, the average structure of real wages needs to fall if unemployment is to be substantially reduced. The macroeconomic policy package outlined in this set of papers should assist in signalling the need for wage restraint, but this will take time to work. The need for an awareness on behalf of unions and employers of the adjustments required in the labour market, together with the need for reforms to the present system of wage fixing, should influence the timing of the move away from wage controls.

Achieving a substantial reduction in unemployment is likely to take time. Meanwhile, in delivering assistance to those who are unemployed, it is important that this does not unduly impede improvements to our overall economic performance or labour market flexibility. The present array of labour market programmes involve substantial expenditures by the Government and these need to be reviewed to ensure that they are cost efficient devices to assist those most disadvantaged by inadequate labour market adjustment.

TABLE 1

ESTIMATED DISTRIBUTION OF FULL-TIME EMPLOYMENT BY INDUSTRY SECTOR[1]

Year[2]	1975	1976	1977	1978	1979	1980	1981	1982
				(percent of total)				
Agriculture, hunting, forestry fishing	10.7	10.5	10.5	11.1	10.6	10.9	11.3	11.4
Mining and quarrying	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Manufacturing:								
Food, beverages and tobacco	5.6	5.6	5.9	6.0	5.6	6.1	6.0	5.8
Textiles, wearing apparel, leather	4.0	4.0	4.1	3.7	3.9	3.8	3.5	3.6
Wood and wood products	2.0	2.0	2.0	1.7	1.7	1.8	1.8	1.8
Paper and paper products, printing, publishing	2.6	2.6	2.6	2.6	2.6	2.7	2.7	2.7
Chemicals, petroleum, coal rubber, plastics	2.0	2.0	2.1	2.0	2.1	2.2	2.1	2.1
Non metallic mineral products	1.0	1.0	1.0	0.9	0.9	0.9	0.9	0.9
Basic metals etc.	7.7	7.8	7.9	7.5	7.7	7.6	7.3	7.5
Electricity gas and water	1.2	1.3	1.2	1.3	1.2	1.1	1.2	1.2
Construction	9.2	9.2	8.8	8.4	7.7	7.1	6.7	6.7
Wholesale, retail, restaurants, hotels	17.7	17.6	17.3	17.0	17.1	17.1	17.1	16.9
Transport, storage and communication	9.1	9.0	8.8	8.9	8.8	8.6	8.5	8.3
Financing, insurance, real estate	6.4	6.5	6.7	6.8	6.9	7.0	7.3	7.4
Public administration	3.8	4.0	4.0	4.4	4.7	5.1	5.2	5.3
Sanitary and similar services	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Social related community services	11.9	12.0	12.1	12.7	13.0	12.7	13.0	13.0
Recreational services	1.2	1.2	1.3	1.4	1.5	1.5	1.5	1.6
Personal and household services	2.7	2.7	2.7	2.7	2.8	2.8	2.8	2.8
Total[3]	99.8	100	100	100.1	99.8	100	99.9	100

[1] Calculated on the basis of full-time employment of 20 hours or more per week. Excludes employment in the armed forces.
[2] Years 1975 to 1979 are from estimates in April. Years 1980, 1981 and 1982 are calculated from estimates for February.
[3] Totals may not add to 100 because of rounding.
Source: Abstract of Statistics, Table 5.02

Chapter Twelve

Social Policy

A INTRODUCTION

In 1983/84, over $8 billion (or 56 percent of total central government expenditure) was spent directly on various social services (see Appendix I). This level of spending represents an increase of 94 percent in real terms since 1970/71 (or 5.2 percent per annum on average), although its share of the total has remained almost constant over that period (i.e. the increase has been at the expense of private expenditure rather than other public activities). In addition, approximately $230 million is redistributed to low income households through tax rebates, and other tax concessions on social services amount to an estimated $540 million. The accident compensation scheme channels a further $250 million (approximately) to social objectives.

Projections of demographic change indicate that, on the basis of existing policies, real growth of social expenditure will continue as a result of the aging of the population. This will occur against the background of a real rate of growth of national income which, on the basis of present policies and economic performance, may not keep pace.

At the same time as this rapid increase in welfare spending has occurred, there has been increasing dissatisfaction with its results, giving rise to pressures for both expansion and retrenchment, and for reallocation. A number of points may be noted:

a it has become clear that increased spending by the state does not necessarily provide proportionately better outcomes or meet people's expectations. In the field of health, for example, the mortality rates for certain age groups have either levelled off or actually increased during a period of expensive advances in medical care. Nowhere is the observation more clear than in the area of law and order. Here, the level of expenditure and outcomes seem to bear little or no relation to each other;

b despite apparently equal access to the traditional social services for all citizens, important differences in education, health and housing standards have persisted among different socio-economic groups. For instance, there is suggestive evidence, at least, that the education system is poorly adapted to Maori and Pacific Island students, and devotes too few resources to special educational needs. Health status differences, also, are often closely aligned with socio-economic factors. In fact some social policies appear to be quite inequitable, even exacerbating inequalities in welfare (e.g. home ownership assistance);

c while social well-being overall has undoubtedly risen and some indicators of health, education and housing standards have shown marked improvement, particular facets of welfare have remained of considerable concern. For example, there are currently 900 people listed with the Housing Corporation as having urgent housing needs. Likewise, the incidence of poverty and fairness in the distribution of income are issues of continuing concern.

Probably the most significant social problem of the 1970s and 1980s has been the rise in unemployment, which has ramifications for social policy in a number of areas including income maintenance, social support services and health care services. Deep-seated social and demographic changes (e.g. in family structure, the role of women, and in the ethnic and age structure of the population) add to the difficulties of social policy.

Against this background, and given the existing fiscal position and scenario (as reported in other papers), it follows that there is an urgent need to review existing and any proposed new social policies. Key issues for attention are:

a the need for government involvement (sections 2 and 3 below) and the costs and benefits involved;

b the priorities of various objectives (section 4)-both relative to other social objectives and relative to priorities in other areas;

c the cost-effectiveness of policies in meeting objectives (sections 5 and 6)-in order to achieve maximum welfare gain at minimum cost.

In Treasury's view there appears to be considerable scope for more effectively meeting social objectives and doing so in ways which minimise costs and distortions. Thereby resources can be released for other desirable uses.

This paper outlines in Part B a general framework for assessing social policy, which could assist in promoting such an improvement, and then considers its specific application to social welfare, housing, education, and health policies in Part C. General conclusions are drawn in Part D. The discussion is introduced by a brief consideration of how social well-being is advanced by better economic performance and individuals' own actions.

B A FRAMEWORK FOR ASSESSING SOCIAL POLICY

1 Economic Performance and Social Welfare

While this paper concentrates on public spending on social services, social welfare is in fact essentially determined by the ability and opportunity to earn an income. Most people's current income is. derived, in major part at least, from either a direct involvement in economic activity (selling services); or from the market activity of a spouse or parent; or from past involvement which allowed the accumulation of savings now available for consumption. Strong individual incentives to improve personal and family welfare underlie the improvements in living standards which have occurred historically. Achievement of social policy objectives, therefore, requires the promotion of a more efficient economy and a stable macroeconomic environment which is conducive to improved living standards and full employment.

The interaction of economic and social performance is not just a question of a growing economic "cake", with consequently less pressure on how it is distributed, but an issue of increased opportunities for individuals to make their own welfare-improving choices. In general, efficiently functioning markets can be expected to maximise opportunities for welfare gains. Conversely, poorly functioning markets-for example a labour market which prices people out of work and poses artificial and prohibitive entry barriers to occupations-limit opportunities and exacerbate the need for social programmes.

It is notable that ways of promoting social welfare which are consistent with better economic performance tend also to be those which take advantage of the strengths of individual incentives, For example, among the most effective ways of achieving welfare objectives may be the development and ratification of wage fixing mechanisms that reward skill and effort, and a tax system that encourages entrepreneurship and work.

2 The Task of Social Policy

Fundamental to our comments on social policy objectives is the presumption that *in general* individuals (or their guardians) can pursue their own interests satisfactorily, or at least as well as others could for them. Exceptions to this general rule include cases where:

a either, some individuals' interests may seriously conflict with the interests of others, or it is in nobody's individual interest to provide a socially desired service, and hence collective action is sometimes considered necessary (e.g. law and order);

b some individuals may be especially disadvantaged (e.g. disabled) or not able to take fully cognisant decisions (e.g. intellectually handicapped persons or children); and

c society dislikes the outcomes which individuals' voluntary market arrangements seem likely to produce, and prefers alternative ones—including the *distribution of income* and of *consumption* of particular goods and services (e.g. it may regard home ownership as desirable).

In designing laws, regulations, and tax, welfare and expenditure systems, society sets the rules which influence people's ability to advance their own welfare through voluntary market exchanges. In setting these rules society has a variety of objectives including equity, security, social harmony, individual freedom and the smooth functioning of markets.

The failure of much government effort to correct perceived social problems arises because it has focussed on desired results (outcomes) and ignored the inherent nature and implications of processes or the rules surrounding individuals' decisions. That is, the question about what is the most efficient means of achieving desirable outcomes has not been addressed sufficiently. Promoting home ownership, for example, might be thought of as a process that would benefit the poor and substantially reduce inequalities. In fact, most home ownership policies appear to be quite regressive in their impact(i.e. redistribute income towards the better-off).

3 Role for Government

Establishing the rules which lead to desirable social policy outcomes (in terms of efficiency and equity) is difficult. Four broad rationales for government involvement can be identified:

a *Public Goods*

Various goods and services have certain characteristics which suggest collective (government) action to ensure their provision may increase society's welfare. It may be in the interests of society to ensure the provision of these "public goods", even though it is not in the interest of any individual or voluntary group of individuals to provide these goods because the benefit could not repay the expense to the individual. This problem may arise because it is very costly to charge people for the benefits of using a service (i.e. they could "free ride"). For example, most people benefit from the presence of a police force but few may volunteer to pay for the service. Similarly, in the health area, abatement of aircraft noise benefits many people but, individually, people may not have sufficient incentive to pay for abatement. In these cases, the costs to individuals of establishing mutually beneficial arrangements (e.g. extracting payment for the benefits derived from a police service, or gaining compensation for aircraft noise) may be sufficiently high to prevent them from doing so. Thus, it may be more efficient for the government to seek some solution to the problem.

Many goods and services are to some extent public (i.e. have these characteristics); but only where these characteristics are of sufficient magnitude is public intervention or correction warranted. This might be attempted, for example, by regulation (e.g. of noise levels), provision of services (e.g. police), subsidisation (e.g. for public good elements of education), or by education and promotion (e.g. vaccination/immunisation). The selection of policy tools is discussed in Section 5 below.

b *Agency Issues*

Some individuals may lack the capacity to pursue their own welfare satisfactorily. For this reason, the state often assumes an agency role in one respect or another for children, disabled, handicapped or psychiatrically impaired persons, and increasingly for the old and infirm.

Underlying the exercising of an agency role by the state is frequently the perception that the state (or its appointed guardians, e.g. providers of services) has more information or is in a position to make more rational decisions than consumers. In some cases, government action may reflect the state's responsibility to protect the weak. There is also debate about the rights of individuals to make decisions which bear upon themselves or their families (e.g. to use certain narcotic drugs) which are harmful or turn out to be wrong in the eyes of others. Considerable complexities are faced in making informed choices about such things as the quality of health care and the benefit of alternative education courses. This information difficulty is more serious for some activities and some individuals than others.

When the government assumes responsibility for individuals' decisions, an inevitable consequence is the reduction of freedom for individuals to make their own choices-in fact, society is indicating that it knows better what is good for at least some of its members than they do themselves. In formulating social policy to improve welfare outcomes, considerable attention has to be given to the reasonableness of this presumption. The more doubt is attached to the proposition, the stronger the case for either not intervening at all or for delivering *untied* assistance-i.e. for redistributing income rather than providing particular services or regulating individuals' decisions. This issue arises frequently in one form or another in specific policy discussions below.

c Merit Goods and Services

A third rationale for government involvement is to promote particular outcomes (including the use of goods and services) which are deemed by society to be intrinsically worthwhile. Such "merit outcomes" tend to be encouraged (which usually implies subsidisation) but not compelled (as with agency issues), Examples include milk subsidies, education, removal of slum housing and home ownership itself (though other reasons may be as important in this case).

While some of these merit goods and services would be widely accepted as worthy of promotion, others might attract less general support. The major problem with merit goods is that perhaps the majority of cases represent the "paternal state" operating to serve the interests of one group (who would almost certainly have consumed the good anyway) by cross-subsidising their consumption through payments by others who may or may not have chosen to consume the good. Subsidies to the arts are a case in point.

As with the public good and agency rationales, there would appear to be no inherent feature of merit goods which dictates that one method of government intervention is invariably preferable to another. Some element of tied subsidy is usually implied but this does not preclude private provision.

d Income *Redistribution*

A crucial role for' government is to improve the social outcomes that would otherwise result from individuals' voluntary exchanges, by redistributing income among individuals, families and other particular groups. Income redistribution may be achieved via both taxation and direct transfer payments-with the final outcome depending on the interaction of the two.

Income redistribution has the advantage of enabling individual choices to be utilised to maximise individual and social welfare. For this reason it is likely to be a more effective way of improving welfare than the promotion of the consumption of particular goods and services (through tied subsidies or state provision).

The four broad roles for the government, identified above, do not (and cannot) determine the desirability or otherwise of any actual or proposed government involvement. All these rationales follow from the conclusion that government action *might* improve welfare, because voluntary transactions may not yield the best possible outcomes. However, for a number of reasons (discussed below), it may be difficult for the government to rectify impediments to voluntary arrangements or to improve upon their outcomes, bearing in mind the inevitable costs of any such attempt.

A further test of whether the government should intervene is whether there is a clear balance of benefits over costs from the proposed action, taking into account considerations of both equity and efficiency. The next and subsequent sections discuss factors to be taken into account in making such a judgment, the first of which is the establishment of priorities among objectives.

4 Establishing Priorities Among Objectives

a *Opportunity Cost Considerations and the Costs and Benefits of Policy* Alternatives

Allocating scarce resources to one activity (or opportunity) implies that other opportunities are forsaken. This "opportunity cost" concept underlies the need for urgent attention to better targetting and more efficient and more cost-effective policy implementation.

Choices have to be made, if only by default, as to whether expenditure on pre-school education, say, is preferable not only to expenditure on alternative public sector uses such as road development, but also to leaving income in the hands of individuals to spend on their own well-being. It is necessary, therefore, that the benefits of current and proposed policies exceed not just their *actual* costs but also the best return that could be achieved from alternative uses of the relevant resources (i.e. *opportunity* cost).

b *Targetting*

One important deficiency of many social services in New Zealand is their poor targetting. Often assistance does not go to those for whom it is intended, or does not go to those with the greatest need. There are four main reasons for this poor targetting:

i the objectives of many policies are unclear. For example, housing policies could be assessed against a number of objectives such as resource redistribution, assistance to the construction industry, the merit provision of "better" housing and so forth. Policy evaluation may be impeded by an absence of clear objectives;

ii the effects of particular policies have been little understood or researched, and consequences have in some cases been undesirable. For example, interest rate and other financial market controls aimed in part at helping low-income borrowers probably have had precisely the opposite effects;

iii very "blunt" policies have frequently been used to assist small target groups. Without effective tests of need, policies can be highly wasteful. Diffusion of benefits over **a** larger than necessary target population lowers the assistance which can be given to those most in need;

iv too little effort has been directed at determining which groups have greatest need.

As is made clear in section 5 below, some methods of policy implementation have greater scope for selective approaches than others.

Under-charging for government services, for example, provides a subsidy to all users irrespective of need. Income-tested benefits which abate benefit income against aggregate household non-benefit income generally allow more scope for targetting assistance. Against this, however, a high abatement rate may reduce the incentive to work, because the net reward from a few extra dollars of non-benefit income might be very small.

5 Improving the Cost-Effectiveness of Social Policy

While government action is frequently chosen in an attempt to promote some welfare objectives, experience suggests that in some circumstances it is difficult for government measures to improve the welfare of particular groups without imposing significant costs on others The fact that voluntary exchanges have failed to produce the "optimal" result does not mean that government processes or measures will necessarily succeed. In selecting means for the government to influence outcomes, a number of critical factors are as follows:

a *The complexities, strengths and interconnectedness of markets*

Various policies adopted for the best of reasons have sometimes sought to use processes which conflict with the fundamental workings of the market, or private incentives. For example, rent controls, to the extent that they do hold down rents in the short term, merely serve to limit the long run supply and accessibility of rental **accommodation,** thus penalising future tenants. The capacity of markets to respond to controls and frustrate their intentions is illustrated by this example. Many studies have demonstrated this perverse effect of controls, and their tendency to discriminate **against the** very poor.

Impediments to the operation of one market often impact on the workings of others. Interest rate controls and their effects on housing are an obvious example. Policies which affect production or consumption decisions (e.g. through under-charging for government services) impact not only on the service in question, but also on substitute and complementary goods and services and on labour and capital markets. The failure to apprehend these connections accounts for a number of social policy failures.

b *The importance of incentive effects*

Welfare programmes, especially tax and transfer payments, also affect incentives for individuals to work and save. For instance, it is arguable that the more generous social security provisions available in New Zealand since 1976 have reduced the supply of labour by those over 60, with a loss of skills and experience and consequently a loss of national output or income. The assumption of too large a role by the state (e.g. in caring for the blind or the intellectually handicapped), can reduce individual or voluntary Organisation effort which is often a highly effective and low-cost way of meeting social needs.

Transfer payments also tend to substitute for private savings, as individuals do not need to make as much provision themselves for retirement or the potential temporary loss of employment. The reduction in private savings available for investment may be especially serious if public saving (a reduction in budget deficits or the achievement of surpluses) does not increase correspondingly.

While the incentive or efficiency effects of transfer payments are often found to be significant, tax rate effects are more complicated. Small changes in tax rates may have little overall impact on work effort or savings. However, steeply progressive marginal tax rates would certainly lead to some reduction in productive effort. Equally important, they would switch individuals' efforts into less productive directions (e.g. higher income people would tend to engage in do-it-youself work rather than increase their taxable incomes and hire labour) and generate tax-avoiding activities. Income taxes, moreover, increase the cost of labour to employers and hence affect resource allocation.

Essentially, these incentive effects are the economic costs of trying to achieve greater equity. Some distortion of production and consumption choices is inevitable when income is redistributed or prices are altered. This is not to say that the probable improvement in equity should be rejected, but that it should be weighed against the potential loss in total community income. Those methods of intervention which interfere least with the relative prices of goods and services could generally be expected to have the least distorting impact on economic choices.

c *Efficiency of Policies*

The arguments in a separate paper concerning the lack of incentives for efficiency in publicly owned enterprises are just as important for publicly provided social services. Without the constraints of the market, there is increased opportunity for public service providers to maximise their own interests rather than to maximise those of their clients. Medical practitioners in public hospitals, for example, may be encouraged to raise the quality and technological level of health care because they face few or diffuse cost signals. State provision accentuates the difficulties in shifting resources to areas of greatest benefit, and tends to diminish the flexibility in *covering* the needs of each different group in society. Resource waste may occur because providers lack sufficient incentives to economise.

Achievement of social and other objectives has tended to be associated automatically with state provision of the services concerned. Alternative methods of delivery (e.g. government financing rather than provision) can have the advantage of maintaining private incentives to economise. Areas of extra potential for diminished state provision and increased incentives for efficiency over the longer term are education (at all levels), institutional health and welfare care (especially for the elderly) and rental housing.

Efficiency considerations are not limited to issues of provision. The waste associated with holding the price of public services below resource costs (e.g. rail and energy charges) have been mentioned previously. Conceptually similar are policies which fail to bring individuals' actions fully to account. Of these, the most notable, perhaps, is accident compensation, which removes all fault and substantially reduces incentives to minimise risks or damage to other parties.

d *Shifting and Middle Class Capture*

The introduction of any programme involving public expenditure (or taxes) has a variety of different effects throughout the economy, conferring windfall benefits on some (e.g. milk producers benefit as a result of milk subsidies aimed at consumers) and imposing costs on others (e.g. fruit juice producers and fruit growers who suffer from the competitive advantage given to milk producers). Under certain conditions, almost all the benefits of a programme may be "shifted" to groups other than the intended targets. Important examples are the likely capitalisation into house prices of subsidies both to new home owners and to urban public transport. The principal beneficiaries of the subsidies could well be existing owners (or those who owned the house when the subsidy was introduced), and not purchasers.

Another failure of many programmes which are targetted at low-income households is that the benefits are largely "captured" by middle and upper-income households. A variety of studies (in countries with welfare systems broadly similar to New Zealand's) have concluded that most public expenditure on the social services is actually distributed in a manner that favours the middle and higher social (income or occupation) groups, despite its notional targetting at low-income groups.

If services are provided free or at a uniform price to all, then it is probable that the wealthy will benefit most. This is because there will always be some costs associated with using services, even if there is no direct charge. Such costs could include the cost of travel involved in order to use the service, the income lost through the time involved in using the service, or the legal and administration costs involved in complying with complex requirements. These costs invariably weigh more heavily on, and discourage, the poor rather than the rich.

The only established exceptions to the finding that middle and higher income groups benefit most from social expenditure programmes, are certain programmes which are explicitly confined by policy decision (e.g. income test) to people on low incomes (and even then this is no guarantee of redistribution). Among the most extreme examples of capture is tertiary education, which in Britain has been estimated to represent a transfer of $5 to the rich for every $1 to the poor. Interest groups (e.g. students' associations) of course often seek to maintain or extend programmes which benefit them on the grounds that they improve opportunities for the less well off. Typically, organised groups comprise principally people who are educated, articulate, and have the resources or spare time to pursue the interests of their group.

6 Principles for Framing Policy

From the foregoing description of factors to be taken into account in formulating policy, several broad conclusions emerge:

a policies which encourage individuals to make choices for their own good can be an effective means of achieving welfare objectives;

b there is a need for increased recognition of the complexities, interconnectedness and strengths of markets. Prices are important because of their twofold effect of providing incentives to producers to minimise resource use and to meet clients' demands, while making consumers aware of the costs and benefits of various goods and services, thereby preventing unnecessary consumption;

c following from (a) and (b), emphasis should often be placed upon the delivery of untied assistance (rather than subsidising particular goods or using them as a vehicle to achieve resource redistribution). Where assistance is tied to certain ends, use of government financing or subsidisation rather than public provision is generally preferable;

d emphasis should be given to the removal of impediments (including government supported ones) to the smoother functioning of markets;

e the rationale for public policy and its objectives should be clearly identified, and the potential benefits weighed against both the costs of the proposal, and the benefits of alternative resource uses;

f attention to the cost-effectiveness of policies, and especially their targetting aspects, is critical to improved social performance.

C APPLICATION TO SOCIAL POLICY AREAS

1 SOCIAL WELFARE POLICY

The Role of Government in Social Welfare

Two fundamental policy objectives appear to underlie the social welfare system, despite its pragmatic evolution in response to particular New Zealand needs, namely:

a *income maintenance*-*to* safeguard individuals in the community against loss or reduction in income due to a variety of circumstances (including age, incapacity, widowhood and unemployment) by providing a secure money income at a level which will enable them to participate in the community; and

b social *work services* to protect the interests of certain especially vulnerable groups in the community (notably children and disabled people) by providing services such as counselling, residential care and rehabilitation assistance.

There seems to be widespread community agreement with these goals and with the government's role in providing them. The government's involvement in undertaking income maintenance schemes and various social work services may be necessary because private groups of individuals or organisations are unlikely to voluntarily effect sufficient transfers to support or protect the needy.

Treasury's main concerns about the social welfare system relate to the income maintenance policies which, in terms of the resources allocated to them, totally dominate the system. In summary, we are concerned whether the foregoing broad goal of income maintenance is being met in the most effective ways:

a in terms of achieving the greatest overall improvement in the community's welfare (e.g. are the policies sufficiently targetted to those most needing income support?); and

b subject to the constraints of minimising both distortionary impacts on economic choices (e.g. reducing incentives to work) and administrative costs, and of ensuring equal treatment between individuals in different circumstances but with similar total incomes (i.e. "horizontal equity").

Our concerns stem from the likely pressure for increasing government assistance to disadvantaged individuals in the community (which is evident in the trends outlined below), and the heightened need for fiscal restraint. The result is likely to be increasing conflict between those social welfare policies which are based largely on *"needs"* (e.g. income-tested, selective benefits such as the unemployment benefit, domestic purposes benefit, sickness and invalidity benefit) and those which are based on what may be thought of as community *"rights"* (e.g. national superannuation and the family benefit, which are universally applied without regard to income).

Trends

Social Welfare spending currently totals about $4.3 billion per annum. Growth in the average amount of benefit per recipient has been contained in recent years as, although the income-tested benefits have been increased in line with the CPI, national superannuation has been increased only to the extent justified by movements in the Average Ordinary Time Weekly Wage (AOTWW).

However, real demand for benefit/pension support continues to increase overall. Real demand for national superannuation is increasing at an annual rate in excess of 2 percent and this more than offsets savings in other areas notably the family benefit and war pensions. Real demand for the unemployment benefit also rose substantially in 1982/83 and 1983/84 although demand has fallen somewhat in recent months. The DPB has also been growing, at about 9-10 percent per annum in real terms. If wages should again outpace inflation, as must be expected over the medium to longer term if improved economic performance is achieved, overall social welfare spending can be expected to increase substantially in real terms, led by the AOTWW-linked national superannuation payments.

The long-term outlook is affected by the eventual passage of the "baby boom" generation out of the work force and into the post-60 age group. At that stage (beginning about 2015) the ratio of the elderly to the work force may become so high as to cause major strains in the funding of the welfare state. Whether, or to what extent, such an outcome occurs will depend on a number of variables able to be determined or influenced by the government. If major policy decisions do prove to be necessary then it would be desirable for them to be taken well before any funding crises emerge.

Policy Issues

Our chief policy concern is that assistance should be targetted in terms of the need to ensure the maximum welfare gain at the least fiscal/economic cost. The main issues are seen as targetting, means of delivery and levels of assistance:

1 Targetting

a *National superannuation*

The present and prospective size of national superannuation expenditure raises the question of whether the scheme can be continued in its present form.

A comparison of the cost of national superannuation with that of the previous partly need-tested age benefit/universal benefit system had it been continued to the present day indicates that the additional cost of national superannuation was about $1,000 million gross as at 31 March 1984 and about $500 million net. Thus, if some kind of need or income-testing, or other alteration to eligibility criteria, were applied substantial funds could be released to redistribute social welfare spending towards other areas of possibly higher economic or social priority, including reduction in the budget deficit. If a fundamental change were not desired there would still be scope for relatively minor changes to eligibility rules that could achieve useful savings at little social cost.

b *Family assistance*

Assistance to the family has emerged as a significant policy issue in recent years with indications that large single-earner families on low incomes may be in need of supplementary assistance. This issue has still to be fully explored but there is a case that better targetting in terms of need is possible for both the family benefit (universal but based on family size) and the family tax rebate (income-tested but not based on family size). The family benefit currently costs about $285 million per annum and the family tax rebate about $160 million per annum. Several policy options are possible and would need examination as to their relative merits. For example, all assistance towards families with children might be delivered through the welfare system which does take account of family size. This could be achieved by an income-tested supplement to the family benefit or by income-testing total family benefit expenditure. At the other extreme, the family benefit might be abolished and the family rebate made more responsive to family size. At this stage we are unable to indicate a preference for any particular option but consider further inter-departmental work in this area with a view to producing recommendations to be worthwhile.

2 Means of Delivery

a This is currently done on a categorical basis and mostly by cash transfer payments administered through the Department of Social Welfare with limited redistribution through the tax system (with the exception of the family and principal income earners rebates). Alternative forms of delivery which may be more cost-effective are possible, including greater, and possibly even total, switching to use of the tax system, as would occur with the introduction of a negative income tax (NIT) system. This would deliver assistance purely on the basis of need (given a satisfactory definition of income) and could be formulated to take account of differences in family composition, incomes and other relevant factors. However the possible dimensions of such a scheme in the New Zealand context have yet to be fully investigated, and until this is done its costs and benefits cannot be adequately assessed.

b Some services in-kind are provided (usually in the form of institutions, family homes, hostels and workshops), either directly or indirectly by means of subsidies to private organisations such as the Intellectually Handicapped Society. The greater use of community care and the correspondingly lesser role of institutional care is favoured because of its scope for improved tailoring to the individual needs of clients. Complete freedom of choice is not always or even often fully appropriate in the social welfare area given the nature of the clientele, especially the young (state wards, foster children, children "at risk" etc) and the handicapped.

3 Levels of Benefits

In the social welfare area the impact of transfer payments (especially the unemployment benefit but also the DPB and national superannuation) on labour market adjustment has always to be considered when benefit levels are set. The central difficulty is determining the trade-off between income maintenance objectives, labour market and broader efficiency considerations. While higher levels of benefits may be desirable on equity grounds, these may be questionable because of their impact on incentives to work and save. Closer review of the adequacy and efficiency costs of benefits should be undertaken.

2 HOUSING POLICY

The Role of Government in Relation to Housing

A fundamental housing policy objective commanding widespread support is that everyone should be adequately housed, i.e. housed to some minimum standard (e.g. to eliminate caravan housing except where freely chosen). Agreement is less widespread over how to attain this goal and over its practical implications. That housing is essentially a private good— that the benefits accrue largeiy to the 'buyer' of the housing-is generally accepted, and therefore society tends to rely on private provision of housing and to take advantage of individual incentives to improve housing standards. Public good or merit good aspects of housing are generally considered to be limited. However, housing does have those features and they do sustain some case for government support for housing. Moreover, society also tends to be concerned that dependants' welfare should not be jeopardised by unwise housing choices. In addition, housing policy is seen by some to be a vehicle for redistributing resources. For these reasons, housing in New Zealand has been widely subsidised, and in some cases provided, by the state.

Major Problems with Existing Housing Policies

Government housing policy is characterised by three chief problems:

a housing policy is not an effective redistributive device and targetting of most programmes is poor, in terms of income or housing need;

b there is a reliance on public provision of services when subsidisation of services probably could better achieve the same goals;

c housing policies have typically operated by altering relative prices (e.g. the prices of buying versus renting) and hence distorting consumption and production decisions. This has tended to have adverse effects on certain groups (e.g. tenants) and on the use of resources.

These problems are discussed below in relation to key areas of housing policy.

1 Home Ownership Assistance

The greater part of the State's assistance to housing is focussed on encouraging home ownership. The major programmes are Housing Corporation lending to first home buyers, the first home mortgage interest tax rebate and the home ownership savings scheme. In addition to these (and other minor) programmes, the government has intervened in financial markets in an effort to assist home purchasers.

a *Housing Corporation lending*

Two chief difficulties with current Corporation programmes are the concentration on provision rather than subsidisation, and the continuing subsidisation of households no longer in urgent need of assistance. The recent move from Loans Account funding to direct capital market funding made more transparent, the extent of the interest rate subsidy involved but a more fundamental change would be for provision of concessional mortgages themselves to be devolved to private sector mortgage institutions, with the Corporation's role being one of identifying qualifying households and subsidising the interest rate facing these households. Some efficiency gains are likely from a transfer of mortgage administration services to the private sector. Whatever the means of assistance delivery, targetting mortgage assistance to those in greatest need requires that the incomes of assisted households be reviewed periodically and their mortgage interest rate concession be adjusted appropriately. This is essential because households claiming assistance are often only temporarily in need, i.e. at low points in their income cycles, and may have substantially higher incomes within a few years.

b *The first home mortgage interest tax rebate*

This scheme is not targetted by income, assets, family size (etc.), and benefits rise (up to a limit) with income and ability to service mortgage debt. Thus the rebate accrues for the most part to purchasers of more expensive first homes. A substantial part of the value of the benefits of the scheme will have been capitalised into house values, thus shifting the benefit to existing owner-occupiers and also increasing the difficulty of tenants saving to buy. The net effect of this programme on tenants is likely to be adverse when account is taken of the impact of the tax burden it entails.

c *The home ownership savings scheme (HOSS)*

Similarly, the HOSS is not targetted by income or according to housing need. There is some evidence that middle-income first-home buyers are the chief beneficiaries and that those on low incomes, with limited capacity to save, do not use the scheme to any great extent. As with the mortgage interest tax rebate, there is scope for phasing out the HOSS or redesigning it to withdraw the substantial subsidies involved from those who could achieve home ownership without assistance.

d *Intervention in the mortgage market*

Regulation of mortgage interest rates, purporting to lower the cost of home finance, in fact probably reduces access of those on lower incomes to mortgage finance. The current government security ratio system, which tends to impose higher ratios on many of the institutions which have a major involvement in housing finance (e.g. trustee and private savings banks) distorts and probably limits the provision of housing finance by the private sector. Co-ordinated financial sector reform is required to restore the ability of mortgage institutions to provide mortgage finance more efficiently and equitably. This should be one of the highest priorities in a programme to reshape housing policy.

2 The Rental Housing Sector

Current housing policies tend to bias households' tenure choice, by emphasising owner-occupation over renting. For reasons already discussed in (l)(b) above, tenants tend to be adversely affected, even if they are intending owner-occupiers. Aside from the above explicit policies for assisting home purchase, home buyers are advantaged relative to tenants by the lack of tax on the implicit rental income of an owner-occupied dwelling. To compensate for this, there may be a case for a rental housing allowance scheme, whereby tenants on low or modest incomes would qualify for rental housing vouchers which they could use towards rent costs in the private sector. A policy of providing income-targetted assistance might allow a fundamental review of:

a rent controls : by reducing the supply of rental accommodation these have probably had adverse effects on tenants' access to housing;

b ad hoc measures to assist landlords : e.g. the accelerated depreciation allowance on new units. The often hasty introduction and short-lived nature of such measures tend to add to uncertainty in the private rental market;

c the extent of state rental housing provision : in our view the current stock of around 58,000 houses is more than adequate to cater to those in urgent housing need. If the private rental sector were to be given the opportunity to efficiently provide housing for those who qualified for rent assistance on grounds of need (i.e. through the provision of some form of rent subsidy payment), the Housing Corporation's "safety net" role could be phased down. A residual role might remain for state rental housing for households to whom few landlords would rent, even with a subsidy available. Subsidisation of market-provided services tends to be less costly than state provision and would allow more flexibility in housing choice.

3 Building Industry Assistance

In addition to biasing tenure choices, current housing policies bias households' choices in respect of dwelling type. Housing Corporation loan limits favour new homes over used homes ($30,000 and $25,000 respectively). For houses financed in the private market, building industry suspensory loans ($5,000) similarly bias first home owners towards building rather than buying, thus inducing some to build despite initial preferences for used houses. This may have unforeseen. costs, e.g. if a household assisted with a suspensory loan sells soon after buying, a capital loss may be suffered which could wipe out a significant part of the household's savings. The benefits of the extra funds available to new home purchasers probably largely flow to the builders and tend to encourage less efficient builders to stay in the industry rather than shift resources to more productive uses. Moreover, the schemes are outdated (e.g. the suspensory loan scheme was introduced in 1979/80 as a one year measure to help the industry adjust to lower levels of demand).

Summary

What appears to be a housing shortage is in general a problem of inadequate incomes among certain groups (a problem which in some cases is aggravated by unemployment or falling real disposable incomes). In Treasury's view this implies that the problem is generally best addressed outside the housing policy context, through the benefit or tax systems.

Nevertheless, if the government wishes to pursue welfare objectives through giving housing assistance, substantial redesign of current policies is desirable. There is wide scope for reallocation of expenditure and reduction of expenditure while better targetting of programmes can ensure more assistance goes to those in urgent housing need.

3 Education Policy

Objectives and the Role of Government in Education

The reasons for government involvement in providing or facilitating the provision of education are typically related to the nature of education either as a public good (which benefits society as well as the individual who acquires it) or as a good with such merit that the government is prepared to support its acquisition. In addition, government involvement in the compulsory schooling sector may be warranted by the problem of inadequate choice or foreknowledge on the part of children. Finally, government involvement also is often seen as a means of improving income distribution and reducing social inequality.

Problems with present policy

Many of the perceived difficulties in the performance of the education sector (e.g. the mismatch between school leavers' skills and the demands of the labour market) reflect underlying problems which are often characteristic of state provision as discussed in the paper on the public sector. These problems concern the efficiency of education resource use in an environment where:

a price signals (reflecting consumer demand and resource costs) do not operate to direct resources to areas of highest return to the community;

b education suppliers are relatively independent of the need to satisfy consumers in order to obtain funding and so incentives to respond to consumer monitoring are relatively weak; and

c competitive incentives to minimise costs are also weak.

In addition, it is apparent that successful education participation is more likely for middle- and upper-income groups and thus the distribution of successful education outcomes is inequitable. This calls into question the effectiveness of education as a vehicle for equalising opportunities.

Education and Labour Market Links

The poor performance of the education sector has adverse effects on the adjustment of the labour market directly and, indirectly on the performance of the overall economy. Demand for education is substantially derived from the need to acquire labour market skills and because of this individuals have clear incentives to invest in education. To the extent that the responses of the education sector are overly lagged in adapting to changes in underlying demand, labour market adjustment is impeded rather than assisted. In addition, the supply of education can also distort supply and demand conditions in particular segments of the labour market by giving rise to barriers to entry (particularly to the major professions) which artificially restrict participation in various activities.

The linkage between education services and social well-being through the labour market in particular is a strong reason why policy review and change in this area is important.

Tertiary Education Issues

Strong social policy reasons cannot readily be established for the direct government supply of tertiary services largely free at the point of consumption. Private education choices at this level are discretionary investment or consumption decisions (that is, tertiary education is more a private than a public good), since the individual users capture most of the benefits of higher education in their own higher lifetime earnings or increased utility. Despite this observation, one clear reason for government involvement in this area has to do with resource redistribution objectives, whereby a government may wish to offset ability-to-pay constraints on tertiary participation. A more selective, targetted approach would meet this objective with least wastage.

Existing problems with tertiary education are essentially those general problems of public provision outlined above, associated with relative insulation of suppliers from consumers, low incentives to minimise costs, and sluggish ability to change resource distribution for optimal return. In addition, the gradually increasing use of relatively inefficient quota methods of rationing course demand is becoming apparent, with clear labour market consequences.

Such an analysis suggests that a relatively strong case can be made for greater use of market processes in the provision of tertiary education, with an important role remaining for state subsidisation. Initially this might be accomplished by recasting and to some extent reducing existing public spending in this area. Significant immediate initiatives could include improving the *pricing* of tertiary services (for instance, more fully charging for the different costs of courses), and implementing *differentiated* government financial ‘support to students (on the basis of need). In the long term, private suppliers, who are currently crowded out of this sector by the dominance of government provision and by a restrictive regulatory environment, could be encouraged to participate. This would improve the responsiveness of tertiary sector supply to consumer monitoring in terms of teaching performance and the range and nature of services.

Staff Use in Primary and Secondary Schools

In the compulsory schooling sector, teachers are presently distributed and class sizes set on the basis of uniform national schedules. This standardisation is largely an administrative device and does not appear to be appropriate for the non-standard distribution of educational needs which vary according to socio-economic background and ability to learn. If educational outcomes are to be improved, some rearrangement of existing staff provisions to permit both greater flexibility and more effective targetting of teaching resources appears necessary. This would improve the efficiency of current expenditure by better allocating a given level of staffing to areas of highest need. In addition to the distribution of staff, there need to be much greater incentives to improve the quality of teaching in the primary sector and to some extent also in the secondary sector.

Any policy initiative which simply leads to the distribution of more staff in the current pattern would not yield as great an improvement in education outcomes as would a targetted redistribution of current spending.

Summary

Shortcomings of the education system in efficiently achieving appropriate education appear to stem largely from the way in which education is supplied. Substantial improvements in the performance of the education sector may require varying changes to the nature and concept of present education delivery. The key issues are the extent of government subsidy appropriate to different education sectors (notably the tertiary one); the targetting of education resources (in order to equalise education opportunities); and the larger question of the extent to which government should directly provide education rather than subsidise it. Increased emphasis on price signals appears desirable. Each of these factors should be considered if the efficiency and equity of existing services are to be improved.

While such changes could be implemented only gradually, the tertiary sector offers greatest prospect for immediate improvement.

4 Health Policy

The Role of Government in Health

Two basic objectives appear to underlie public health policy in New Zealand:

a to ensure that all members of the community are able to have an adequate standard of health care; and

b to alert people to ways in which they can reduce the risks of their being afflicted by accidents and illness, and to encourage them to take preventive action.

Few would disagree with these goals. In Treasury's view, the crucial issue regarding health policy is whether the existing means for achieving them are the most cost-effective.

The role of government in the promotion of these objectives is based partly on the view that individuals are not entirely responsible for their state of health (e.g. the contracting of many illnesses is often beyond the victim's control). Also society tends to view good health as intrinsically worthwhile (i.e. a "merit good"). In addition, there is a case for government involvement insofar as some individuals, such as children and old people, are typically unable to adequately look after their own welfare.

Underlying Problems with Health Policy

Remedies for what are perceived as continuing health problems, such as high levels of infant mortality and life-style related illness, need to take account of some apparent underlying deficiencies in the structure of health delivery.

In our view the ways in which government structures health services and subsidies should allow resources to be allocated (in both the public and private sectors) so as to achieve the greatest benefits at least cost.

There are two main reasons why resources may not be being put to best use. First and foremost, the provision of many health services at no charge to consumers removes the role of price signals in ensuring that the amount and quality of services reflect as closely as possible consumer demands and the costs of supplying them. Second, the provision of health services via government-funded institutions tends to reduce the incentive for suppliers to provide services at least cost. In addressing these two structural problems, consideration needs to be given to income assistance policy in order to ensure that those on low incomes continue to have adequate access to health care.

These problems are discussed in relation to what we see as the key areas for improving health system performance.

a *Prevention of life-style related health problems*

Accidents, alcohol and drug abuse (including smoking), and mental illness-which are major health problems in New Zealand-have a predominant common feature in that their causes are generally regarded as life-style related. There is increasing recognition that factors over which society and the individual may exert a large measure of control continue to cause undue illness and death. Hospital statistics show, for example, that accidents are the major cause of all hospital admissions and are responsible for the loss of one third of potential years of human life. Again, one in every four admissions to psychiatric hospitals is for alcohol related conditions.

Although preventive programmes, such as health education, can be an effective approach to limiting or suppressing many forms of illness, the major life-style related health problems which remain may be less susceptible to this approach. The significant increase in the costs of the ACC illustrates what tends to happen to expenditure when people have little disincentive to take advantage of the benefits of a scheme and little incentive to take action themselves to reduce the risk of accidents. These considerations suggest that there is scope for the more direct use of incentives to persuade individuals to do more to safeguard their own health. Greater use of charging patients in respect of the health care associated with their own actions, and/or health and accident insurance, incorporating some fair and reasonable “loadings” on to those who are in high risk groups, may encourage desirable behavioural changes. This would only be feasible in conjunction with appropriate income assistance policies.

b *Primary health care-including GMS Benefit.*

A major shortcoming with the GMS benefit is that it is not targetted in terms of income nor in terms of maximising health outcomes. If, for example, the health status of certain “at risk” groups is thought to be prejudiced, a more specific focus would appear warranted than an expensive general increase in the GMS benefit which subsidises health services for all.

c *Community health care*

The widespread recognition of the advantages of community health care (i.e. involving the provision of care in less institutionalised and generally lower cost forms) have not been reflected in any significant real growth in expenditure on community health care. Indeed, expenditure in this field over the past two decades has fallen as a proportion of total government expenditure on health (from about 15 percent in 1960/61 to less than 12 percent in 1979/80, according to the Health Department). To some extent, this failure to shift resources to areas of higher potential benefits may reflect the orientation of health services to the preferences of suppliers, rather than to the preferences of their clients. Community health care may have the capacity to reduce health delivery costs while making that care more responsive to consumer needs and more accessible to disadvantaged groups.

Summary

In our view, improvements in health outcomes can be achieved by identifying the principal areas of poor health performance and developing ways of delivering assistance which are both more cost-effective and better targetted to the “at risk“ areas.

D GENERAL CONCLUSIONS

It is not surprising that standards of individual and social welfare in New Zealand have come under pressure as a result of a lengthy period of mediocre economic performance. Thus the education, housing, health and social welfare systems have been operating under difficult conditions. General improvements in social indicators and our ability to provide more resources in aggregate to those aspects of social service provision which government wishes to undertake will only be feasible with substantial improvements in economic performance, and these will not be rapidly achieved.

In the period of resource constraints which lies ahead, there nevertheless appears to be considerable scope for improving the performance of social service policies. This applies to each of the four broad policy areas discussed above. The sorts of change that we think may produce such improvements fall into two key categories:

a those which would target social policies more on the basis of need—which inevitably would require reducing government expenditure on those people with less need; and

b those which would allow the strengths of market processes to help allocate resources in ways which are more responsive to consumers' preferences and which involve least cost. This should increase prospects for maximising the community's welfare *provided that* adjustments are made to income redistribution policies-otherwise people with lower incomes or special difficulties could be disadvantaged as a result. Indeed, a change in emphasis from provision of particular social services towards direct income redistribution appears fundamental to achieving greater equity in social outcomes.

Although it may be difficult to win acceptance for some of these changes, the fact remains that without such changes social policy objectives are likely to become increasingly difficult to achieve.

APPENDIX I

SOCIAL SERVICES EXPENDITURE

	1983/84	*1970/71*
	(In 1983/84 $m)	
Expenditure Plus Net Lending		
Education	1674	1153
Health	1801	1093
Social Welfare (including $2407 million for national superannuation; $312 million unemployment benefit: $296 million family benefit; $320 million domestic purposes benefit)	4127	1764
Housing	265	253
Other Community and Social Services	45	14
Labour (excluding government contribution to ACC, $30 million)	363	30
Total Social Services Expenditure:	8295	4307
Total Central Government Expenditure:	14929	7982
Percentage of Total:	56%	54%
Accident Compensation (includes government contribution)	253'	
Tax Expenditures		
Family and Principal Income Earner Rebates	235	
Education (school fees deduction and bursaries exemption)'	40	
Housing (first home mortgage interest rebate $80 million); rates relief $20 million; excludes subsidy on interest through Housing Corporation lending) ..	100	
Social Welfare (includes deduction for superannuation and life and accident insurance ($250 million) and non-taxation of benefits ($140 million))	390	
Health	10	
Total Tax Expenditures:	775	

*1982/83

Chapter Thirteen

The Public Sector

The resources used by the public sector excluding transfers amount to around 25 percent of GDP and therefore the efficiency with which these resources are used has a major impact on the growth and general performance of the economy. In examining the potential for improved public sector performance it is useful to distinguish between the "market" activities of the government (where the output is or could be sold) and "non-market" activities (those which, at any point of time, governments have decided should be provided collectively on the community's behalf).

The first section of this chapter deals with market activities. Since the output of these "State owned enterprises" is or could be sold, they have a close correspondence to private sector enterprises. In looking at the question of their efficiency and the accountability of management for their performance; it is useful to consider the way these issues are resolved in the private sector. In the light of this comparison the paper discusses the obstacles to improving efficiency and suggests ways they might be overcome.

While similar principles of Organisation are applicable to the non-market activities of the government, the nature of their output requires other techniques to be used in order to ensure their efficiency and management performance. The second section of this chapter addresses these issues.

1 State Owned Trading Enterprises

Background

State owned trading enterprises play a major role in the New Zealand economy. They account for over 12 percent of gross domestic product and 20 percent of gross investment. Some are larger than any New Zealand publicly listed company e.g. New Zealand Electricity has assets on a current cost basis, of around $12.6 billion, about four times those reported by Fletcher Challenge; on the same basis the Forest Service's exotic production forests are valued at approximately $4.5 billion; and the Post Office has an annual turnover of $1.4 billion and over 38,000 staff.

State owned enterprises are structured in a variety of ways:

a as departments of State with policy advice and regulatory as well as trading functions e.g. Ministry of Works and Development, Forest Service, Computer Services Division of State Services Commission, the Post Office;

b as statutory corporations with special privileges and obligations e.g. Railways special status and BCNZ with licence income; and

c companies registered under the Companies Act e.g. Petrocorp, Air New Zealand.

They are involved in a wide variety of sectors, e.g. Mines, Tourist and Publicity, MWD workshops, BNZ, Post Office.

The origin of many State enterprises can be traced back to earlier perceptions about the shortcomings of markets. Ownership by the State was seen as a means to increase competition, support failing industries, fill a market "gap", or produce a more socially desirable level or form of output. In this sense State ownership is simply one of many forms of government intervention. The chapter entitled "Meeting Government Objectives in the Private Sector: Regulation and Industry Assistance" outlines a framework for evaluating government intervention in the private sector. The most appropriate pattern of government intervention and private initiative is that which contributes the greatest amount to community welfare, taking account of both benefits and costs to the nation overall. The issue addressed here has a different focus. It examines the question of whether there is room to significantly improve the contribution of existing State owned enterprises to the Government's broad objectives.

State Owned Trading Enterprises and Economic Performance

Given their aggregate size and role in the economy the State owned enterprises have a major effect on national economic performance. If they are to have a beneficial effect two essential efficiency conditions must be met:

a their output must be worth at least as much as the resources used; and

b that output must be supplied with the least consumption of resources.

The main factors which determine whether or not these requirements are met are the pricing of the enterprise's output and the way it uses resources.

A *Pricing*

The pricing policies of State owned enterprises affect the following:

a the demand for their output and thus their scale of production;

b consequently, their investment requirements; and

c the use of their output, and of resources generally, elsewhere in the economy.

Thus, for example, the pricing of electricity helps determine consumption which in turn determines the need to construct new hydro generating capacity. The price of electricity relative to gas affects the use of the gas and other fuels.

Appropriate pricing of the output of State owned enterprises is an essential precondition for ensuring resources are put to their best use. The key requirement is that the price of output should cover the full cost of supplying it, including the cost of capital. Such pricing ensures that purchases, and consequently production, are undertaken only to the extent that the value the user derives is at least as much as the resources used.

To the extent the Government considers that the output in question has a value to the community over and above its value to the user, a subsidy might be justifiable to reduce the price and thus increase consumption. Setting price equal to costs less an appropriate subsidy will ensure that purchases are made to the extent that the value the consumer privately derives plus the additional value the community derives from those purchases is at least as much as the value of the resources used.

In general, pricing below the cost of supply has several adverse effects:

a it results in additional purchases which users would not have made at the higher, cost-recovery, price level and which must therefore be worth less to them than the cost of supply. Thus output is produced which is worth less than the resources consumed;

b usually additional investment will be required to meet the expanded demand and this will be one of the ways in which resources are diverted from other uses more highly valued in the market to produce this less valuable output;

c the wider effects of underpricing include the possible forcing out of production of private sector producers which may have been more efficient than the State owned enterprise;

d users whose requirements could be met more economically by other products may switch instead to the State owned enterprise's product because of its lower price. Such switching to products which use more resources to meet the user's requirement can be very detrimental to overall economic performance;

e underpricing by State owned enterprises results in a greater call on the taxpayer for funding and less return by way of dividends. This inevitably increases the tax burden either immediately or, if financed by an increased internal deficit which is itself financed by borrowing, in the future to repay loans.

Equally if enterprises price above the cost of supply which is likely to occur when they are protected from competition, their output is denied to users who would be prepared to pay its cost of supply. For example, if the Post Office overcharges for toll calls some communications between different parts of the country for which users would be prepared to pay the true costs involved will not be made. Instead, there will be communication by means which achieve the user's requirements less efficiently e.g. travel or mail, or else no communication at all.

B *Management* of Resource Use

The use of resources in a State owned or any other trading enterprise is the outcome of decisions throughout the Organisation including those relating to following:

a the management of existing resources i.e. in day to day operations;

b decisions on investment; and

c the management of investment projects.

The contribution of the enterprise to national economic performance depends considerably on its management's performance in each of the above areas. While major decisions may be amenable to analysis and to consideration by Ministers, only the management has the detailed information required to ensure that resources are used to best advantage in general. However the managers of most private sector and State owned enterprises do not directly bear the consequences of their performance. Rather, managers are in the position of agents for the principals— shareholders or taxpayers-on whom the consequences fall. In both cases an "agency" (or accountability) problem arises, namely how to ensure that management acts in the best interests of the principals, An adequate solution requires that the monitoring of managements' decisions and the outcome thereof should be integrated with arrangements which provide incentives for efficiency. Such incentives are provided in the private sector by, for example, the way the sharemarket responds to management's performance by movements in the share price which affect the management's access to capital and exposure to takeover. It is difficult to generate such strong incentives for the management of State enterprises, but arrangements such as rate of return objectives and agreed dividend requirements have some of the desired effects.

Arrangements to ensure that management is accountable involve a trade-off between the benefits of achieving better management performance and the costs of doing so. Those costs include perverse effects created by such arrangements, such as opportunities lost because of limits on management's discretion.

In many cases existing provisions regarding the accountability of State enterprise managements do not, in Treasury's view, incorporate appropriate incentives for efficiency. Obstacles to the development of arrangements which would provide more effective incentives and ways of overcoming such obstacles at least cost are discussed in detail later in this chapter.

C Fiscal Effects

Improved economic performance of the State owned enterprises would have a significant effect on the Government's fiscal position. Achievement of adequate rates of return on the very substantial assets of such enterprises, which the taxpayer has financed by Public Account advances or by foregoing dividends in the past, could generate considerable net government receipts. For New Zealand Electricity alone net receipts could rise by several hundred million dollars. Substantial gains are possible in other areas.

Factors Adversely Affecting the Performance of State Owned Trading Enterprises

Some of the factors which at present cause many State owned enterprises to contribute less than they could to economic performance through their pricing policies and management of resources are:

a their lack of clear, non-conflicting objectives;

b their operating environment i.e. the special assistance they receive and restraints on competition with them; and

c the incentives arising from existing arrangements for monitoring performance.

A *Conflict of Objectives*

State owned enterprises are obligated to achieve a plethora of non-commercial objectives. These include:

a maintaining services (e.g. rural postal service);

b increasing employment-job “creation” (e.g. Forest Service); and

c artificially holding prices below the cost of supply (e.g. electricity, coal).

These objectives often relate to the important goal of equity in the economy. However, where management are charged both with performing a general social function, without compensation for the cost involved, and with achieving an adequate return on resources used, major conflicts of objective result:

a management of organisations do not themselves have any clear way to resolve the trade-off between objectives. It is not clear to them what costs they should accept in deciding how far to pursue a particular non-commercial objective. Determining the value of, and hence willingness to pay for the costs of a non-commercial objective should rest with the Government rather than the management of a State owned enterprise;

b management usually find that the most convenient way to fund the cost of achieving non-commercial objectives is by cross-subsidisation from profitable activities. This results in the costs incurred and advantages delivered being concealed. For example, the Post Office overcharges for some services to subsidise the provision of others. It is not clear how much this practice costs, or who receives the benefits (large businesses may be the most substantial beneficiaries). It is therefore difficult to judge whether the policy is worthwhile;

c the monitoring of the performance of the enterprise with regard to efficiency objectives becomes very difficult. Having to perform social functions can be as much an excuse for poor management as a genuine reason for unsatisfactory performance.

The non-commercial objectives are important, but to avoid the above problems the means of achieving them need to be carefully considered.

a *Maintaining* services: For example, to meet the objective of providing social services (e.g. mail delivery to rural areas) the specific services and their cost can be identified and subsidised explicitly by a payment to the enterprise or to its customers. (This is the arrangement for Railways social services.) In that way the decision about the extent to which services will be subsidised remains with the Government, the cost is known, and the conflict of objectives is removed. Furthermore, the Government does not need to actually own and produce the service itself to see that it is provided. It could purchase the service from competing enterprises on a commercial basis for delivery to target groups, thus ensuring strong incentives for least cost provision.

b *Increasing Employment:* To achieve the objective of increasing employment it is more efficient to aim at increasing employment across all organisations within the economy rather than to instruct particular State enterprises to take on more staff. It is argued elsewhere in this brief that excess staff in State organisations will only displace employment opportunities elsewhere in the economy over the medium term and that employment can only be increased by appropriate macroeconomic policies, efficient resource use and labour market flexibility. Funds used to support State enterprises or funds foregone because of their poor performance reduce the capacity of the Government to finance, among other policies, employment programmes targetted on specially disadvantaged groups.

c *Pricing:* The prices of goods and services produced by State owned enterprises (particularly coal and electricity prices) are sometimes held below the cost of supply in an attempt to help constrain price inflation or to assist users. However, this stimulates the demand for the enterprise's output, squeezes competitors out of the market and increases the call on government funding as investment increases to meet the stimulated demand. Attempts to reduce inflation by holding down individual prices just delay the time of passing on cost increases. In the meantime it destroys the important function of prices to convey to users the true cost of supplying goods or services. The inflation rate is more effectively lowered through macroeconomic policies concerning the budget deficit and monetary growth. Attempts to assist particular groups by artificially low prices are not cost effective since all users benefit rather than just the group which is of concern.

It follows from the above examples that non-commercial objectives, which aim at promoting equity, can be generally achieved in ways which do not detract from the commercial performance or efficiency of the enterprise. This can be accomplished either by using some mechanism quite separate from State owned enterprises to achieve equity or by "commercialising" the objective for the State owned enterprise by paying a subsidy. Making this separation between the way equity and the way efficiency are accomplished has the following advantages:

a the level and cost of assistance can be clearly identified as a better basis for making decisions;

b the government, rather than the enterprise, can decide how much assistance is to be given;

c assistance can be better targetted; and

d most importantly, clear commercial criteria can be established to assess the management's performance.

B *Operating Environment*

Apart from the lack of clear non-conflicting objectives the second factor most affecting performance is the environment State owned enterprises operate in. This environment is frequently characterised by a multitude of special privileges and constraints.

a *Special Assistance:* Commercial advantages are given to State owned trading enterprises in a number of ways but all have the effect of detaching the costs the enterprise faces from the true cost of the resources used and hence weakening incentives to operate efficiently. The most important advantages are:

i subsidised finance, for example, Loans Account advances at low interest rates. This causes enterprises to use more capital and less of other inputs such as labour than otherwise. Because finance costs less, the enterprises need not be as concerned about the most effective use of finance;

ii lack of pressure to achieve a return on capital employed where equity finance is provided without dividend and related requirements (e.g. Shipping Corporation, BNZ);

iii many State enterprises are not subject to taxation which may also effectively reduce the cost of finance.

The above factors may enable prices to be held down artificially resulting in adverse effects, including excessive expansion, as described earlier. They also exacerbate the problem of monitoring performance since they further weaken the link between the performance of the State enterprise and that of its private sector counterparts.

b *Competition:* Lack of competition can enable an enterprise to continue producing poor quality/high cost services and still keep customers. Competition-or even the threat of potential competition-is a very effective means of ensuring that managers are performing. It stimulates more cost effective methods of production and helps ensure prices are kept to a minimum. In a competitive market users provide incentives for enterprises to be efficient by switching demand to those offering the best product at the best price. Its absence in a rapidly changing area such a telecommunications would seem likely to slow down the uptake of new technology. Objectives of efficiency and international competitiveness of telecommunications users are thereby jeopardised.

Introducing competition in the transport sector has led to major improvements in efficiency. In many cases there have been major reductions in freight rates with individual firms reporting rate reductions of 30 or 40 percent and more. Increasing competition has stimulated the Railways Corporation to adapt to customers' needs and reduce costs thereby making users more internationally competitive.

A particular barrier to competition occurs when State enterprises have both a trading enterprise and a control or regulatory function. For example, the Computer Services Division of the State Services Commission both supplies computer facilities to departments and determines which computer services departments must use. The Post Office has responsibility for policy advice and regulation in the telecommunications area in which it has its largest commercial interests. In such cases a conflict of interest may arise. Institutional arrangements such as those in the broadcasting field where the operational Organisation (Broadcasting Corporation) is separate from the control and regulatory function (Broadcasting Tribunal) are preferable.

State ownership of trading enterprises has sometimes been advocated where it is considered to be most efficient to have only one supplier. It is argued that State ownership is a means of providing the most efficient solution while avoiding the abuse of monopoly power. However, in a number of cases institutions which were created to prevent the abuse of monopoly power have later come to rely on government support to maintain their position. In some areas where competition is excluded only certain parts of the enterprise are monopolistic in character (e.g. the transmission of electricity may be naturally monopolistic but its production and sale can be made competitive). In other areas, such as telecommunications, technical changes have removed much of the natural monopoly but legislative restrictions continue to prevent competition.

C Incentives Facing Management:

Current arrangements for monitoring performance are inappropriate in a number of ways:

i control departments have tended to focus on inputs rather than outputs and on proposals rather than results. Generally there has been little monitoring of past performance to ensure corrective action and where deficiencies in performance are reported to the Government, enterprise managements tend to argue strenuously and often successfully against change. The infrequent post-audits that have been done have shown disturbing results. Typically post-audits are carried out only after the organisations have run into serious problems, e.g. Air New Zealand and Railways;

ii many current methods of control by Treasury and the State Services Commission can impose significant costs on the enterprise and inhibit its ability to take advantage of opportunities and to respond adequately to problems. For example, controls on conditions of employment and staff ceilings may make it difficult to attract the employees required to improve performance. Such controls are, however, required where major non-commercial objectives or protection from competition and other assistance make other methods of monitoring and accountability ineffective;

iii currently there are no benchmarks against which performance can be assessed. Any comparisons are confused by differences in accounting practices and more importantly by the widely different advantages or disadvantages faced by various State enterprises. Some progress is currently being made in establishing benchmarks for Government Print, Ministry of Energy, the Post Office and Air New Zealand. Financial objectives are being established, financial structures reviewed and corporate plans developed. However, financial objectives in themselves are not sufficient to monitor efficiency where enterprises can increase charges because they are not subject to competition. Most importantly, procedures for responding to failures to achieve objectives are yet to be developed.

Solutions

In summary, there are a number of specific factors which are obstacles to the development of appropriate incentives for efficiency. The contribution of State owned enterprises to national economic performance could be substantially improved by removing these obstacles and replacing them with objectives and an environment which provide appropriate incentives as discussed below:

A Non-commercial objectives

If non-commercial objectives can be achieved satisfactorily by some other means, that should be done. The social objectives which remain with State trading enterprises should be "commercialised", for instance by paying a subsidy to cover the extra costs involved. Policy and regulatory functions should be separate from trading operations.

B Removing special assistance and barriers to competition

Commercial advantages and disadvantages need to be eliminated, particularly barriers to effective competition. This will ensure that the enterprise uses the level of resources commensurate with its relative performance. It will also enable the performance of State owned enterprises to be fairly assessed by comparison with returns earned elsewhere.

C Setting measurable targets

Clear, measurable targets should be established based on private sector norms of profitability. The best possible means to monitor enterprises is to compare their performance with what other managers have achieved or could be expected to achieve in similar circumstances. Hence, criteria need to be set which can be used to compare an enterprise with the performance of other enterprises in the public and private sectors. Comparisons with a private sector counterpart requires that both enterprises report their results on the same basis. It also requires that they face the same level of assistance. This is not the case, for example in the present operating environment where on the basis of their annual report New Zealand Electricity has a 24 percent return on shareholders funds (retained earnings) in 1982/83. If they were established on a footing broadly comparable to the New Zealand corporate sector NZE's return on shareholders funds is estimated to be *minus* 3 percent in 1983/84 compared to an average for the New Zealand corporate sector of around 12 percent. The poor return reflects the amount prices are below the full cost of the supply and the scope that exists for improvements in internal efficiency.

D Corporate Plans

Corporate plans would then be required to identify the most appropriate direction of development, to translate the targets into objectives and performance criteria for lower level management in a consistent way (e.g. divisional goals).

E Information Systems

Information systems relating to accounting, financial and technical aspects of the enterprise are required to enable the corporate plan to be implemented and performance assessed.

F Accountability

Accountability needs to be highlighted so that managers have the incentive to strive to meet the targets. It is useful to appoint an advisory board or board of directors over management where none currently exist (e.g. the Forest Service and Post Office). In this way private sector expertise in monitoring management can be tapped. The regular reporting of actual performance against targets to Ministers, to the Public Expenditure Committee and to the public is an important mechanism to heighten accountability. Another mechanism, not yet developed, is to ensure that the earnings of managers reflect performance of the enterprise as in the private sector. Action to change the management will be required, not only where enterprises regularly sustain losses, but also where positive returns are being achieved but comparisons show that they are relatively low.

Conclusions

Because of their combined size and their roles throughout the economy, State owned enterprises have a major effect on national economic performance via their pricing policies and the efficiency with which they use resources. Substantial improvements in their currently poor performance could be achieved by implementing the measures discussed above to provide appropriate incentives for their managements. For each enterprise a programme would be required to apply the general solutions outlined to their individual circumstances. Ministerial commitment to the exercise and the co-operation of the management involved would be needed for success.

For some enterprises additional gains in efficiency as well as benefits for the fiscal deficit might be achieved by their sale to the private sector as discussed in the Appendix to this chapter.

2 Management of the Public Service

Introduction

This paper is concerned with the broad issues of efficiency and management of the public service.

Background

The state service, broadly defined, encompasses a total workforce of well over 100,000. Working under Cabinet's direction, it is responsible for the effective use of government expenditure of around $17,000 million which includes over $4,000 million in transfer payments, around $1,300 million in capital expenditure, over $5,000 million in wages and salaries and around $5,000 million in expenditure on goods and services. It is easily the biggest employer in the country and has the biggest budget. The quality of its advice to the Government and its effectiveness in implementing governmental decisions can have a major impact on economic performance. If economic performance overall is to be improved, it is essential that the public service itself operates within an environment that fosters good performance, and that it is efficiently managed. Given the magnitudes involved, even minor general increases in efficiency may allow significant increases in spending in priority areas, or reductions in taxes or the fiscal deficit.

The public service has two major responsibilities to the Government: to advise it objectively and rigorously on the policy issues with which it has to deal, and to implement decisions in the most effective way possible.

An effective management system for either of these tasks requires the following main attributes-clear objectives, appropriate incentives for performance, clear accountability, delegation of authority and responsibility to the most appropriate level. It also requires suitable people to run the system.

In any Organisation the management should have goals established by the owners. They should also have incentives, monetary or otherwise, to achieve the Organisation's goals. These should include rewards for good performance, and penalties for poor performance. This in turn requires that managers are accountable for the decisions that they take. It is essential that if authority is delegated, then so is responsibility, and vice versa.

The private sector relies on the market system to perform most of these functions. Normally, in a competitive market, the profitability of a company indicates how well it is using resources, and the owners of a company have the responsibility for ensuring that the company adjusts to changing environments. For large listed companies, the fact that the share price reflects the value of the company places a discipline on the managers of the company to perform efficiently. The private sector has a fair degree of freedom in deciding on the best way of meeting its objectives, and the best use of its resources, including labour.

Some of the functions that the market performs in assisting the private sector to meet its objectives also impact on the public service, as it competes for resources, particularly labour, with the private sector. However, many other functions that the price system performs in the private sector must be performed by other means in the public service.

The aim of management should be the implementation of systems in the public service that can perform broadly the same role for the public service as the price system does in the private sector. The ideal management system in the public service should have the following major features:

a as much relevant information as possible should be in the hands of the Government before decisions are taken;

b each government agency should have clear objectives set by the Government;

c these objectives should be clearly stated in such a way that measurement of progress to meet those objectives is possible;

d each government agency should have a management plan, approved by its Permanent Head and Minister to meet the Government's objectives;

e the activities of each agency should be regularly reviewed against the agency's objectives and management plan;

f the managers of agencies should have the freedom to choose the best mixture of inputs to get the agreed output, within the overall financial limits set by the Government;

g there should be appropriate incentives to encourage the management and staff of each Organisation to perform effectively.

Government Structure

Cabinet has the overall responsibility for control of the government machinery, but it has delegated a good deal of authority to Ministers and to Cabinet Committees. Departmental expenditure decisions on matters other than staffing are normally made by the Minister of Finance in the annual Budget cycle, as described in another paper. The present Cabinet Committee structure charged with responsibility for the state sector is fragmented, with separate committees responsible for reviewing general expenditure, staff issues, and capital expenditure. No single government body is responsible for reviewing overall expenditure, nor for focussing on broad management issues. (Although Parliament's Public Expenditure Committee has attempted to fulfil that role from time to time, it is not a government body).

Departmental Structure

To some extent, the structure of departments reflects the Cabinet Committee system. Treasury is responsible for the control of expenditure that is appropriated by Parliament. On a day to day basis, the Treasury reports to the Minister of Finance on the detail of policy. Much of the review of expenditure that is carried out is in the context of the Budget cycle. The detail of the expenditure control system is discussed separately in this brief, along with proposals for improvement. However, these proposals focus on the control of expenditure, not on the broader question of the management of departments or the review of individual activities.

The Treasury is closely involved with the Cabinet Committee on Expenditure, which has been responsible over the last few years for approving the plans of Ministers and departments to introduce new policy, by offsetting the cost through compensatory savings. The Committee has not been involved in assisting in the management of departments.

The State Services Commission is the legal employer of most of the country's public servants, and runs the state pay system. It is also responsible for industrial relations issues. Its counterpart Cabinet Committee has been the Cabinet Committee on the State Services. The Commission is also responsible for helping departments with management reviews. These reviews normally focus on narrow issues, and have not normally been concerned with the broader question of the best use of resources. There is probably insufficient liaison between the Treasury and the State Services Commission on management issues.

The Audit Department is responsible for monitoring the expenditure of departments and seeing that expenditure is in line with the authority given by Parliament.

The fragmentation of responsibility among Cabinet Committees is matched by the same pattern in the so-called control agencies. One result of this structure is that a good deal of emphasis is placed on controlling inputs-especially the amount of labour used, although not the wages paid for that labour-and less emphasis is placed on monitoring output and performance in meeting goals. There have been some changes in this area over the last few years, with some departments being moved to a bulk allocation system of funding, but most departments still face detailed control over their use of inputs, with much less monitoring of what they produce.

Departmental Management

Departments are run by Permanent Heads, whose responsibility is to the State Services Commission and to Ministers for running their departments effectively. However, Permanent Heads either face unclear objectives, or alternatively face objectives that can be hard to measure. Although some departments now have some form of management plan, most still do not. The process of review is also difficult. If a department has no clearly specified objectives, it is difficult to comment meaningfully on its performance. This in turn makes any change in role difficult to implement. There are no regular reviews of the performance of Permanent Heads and, in turn, Permanent Heads have little say over the pay and conditions of their staff, and face considerable difficulty in either rewarding good performers or, particularly, in dispensing with poor performers. They are also very constrained in their ability to recruit skilled and experienced staff from outside the public service above basic grade positions. To some extent, control and responsibility are diffused and, as a consequence, so is accountability.

It is often argued that the nature of public service outputs make it difficult to measure the performance of agencies, even if their roles were more clearly defined. However, this difficulty should not be exaggerated. An agency like the Treasury, for example, with major responsibility for policy advice and much less operating responsibility, can specify its objectives in general terms and could translate these into a set of tasks for a particular year. At the end of the period, it would have to have performed those tasks, or have definite reasons for not having done so. Similarly, most operating departments should be able to specify their goals in such a way that their performance can be more effectively measured.

In summary, the major criticisms that can be levelled at the public service are:

a most departments have no clearly defined goals;

b most departments have no clearly specified management plan;

c there are few effective control mechanisms to review the performance of departments in meeting their output requirements;

d departmental managements have little freedom to change the way their departments operate to meet their goals, especially in staffing matters. They lack the autonomy they need, within an overall expenditure limit, to use their judgement to produce the best outcome;

e too much emphasis is placed on the control of inputs;

f there are no effective review mechanisms for dealing with poor performance in senior management within departments.

Proposals for reform of the structure fall into the following areas:

Government Structure

Another paper discusses the possibility of changing the Cabinet Committee structure as part of an overall reform. One or more executive committees could take over the functions of the Cabinet Committees on the State Services, the Expenditure, and Works. The Committee(s) would, however, operate within the broader economic framework set by a superior policy review Committee.

As well as assuming more responsibility for the control of expenditure, as is suggested elsewhere, the committee(s) in question could formally require from each Minister and Department a clear specification of the objectives and functions of each department under review. After satisfying itself, in conjunction with the Minister responsible for that department, that the functions and objectives of each department were in line with government policy, the Committee would require that each department prepare a management plan. The performance of the department would later be reviewed against the objectives set out in the plan, as discussed below. (The Committee might also liaise with the Minister of Finance and the Minister in charge of the department over the appropriate level of resources for that department.)

Departmental Managers

There is a case for placing more responsibility on Permanent Heads. They would be responsible for preparing their management plan and, following its endorsement by the Government, they would be responsible for implementing it and achieving the goals that had been set for the department.

This greater responsibility should desirably be matched by greater freedom for managers to meet the goals set by the Government. In particular, they would have to have greater freedom in managing staff. Perhaps the most appropriate mechanism would be for the Permanent Head of a department to be the legal employing authority, with a responsibility for the most efficient and effective use of his or her staff.

This would require major changes to the state pay fixing system, which is at present very centralised. The main mechanism for increasing state servants' pay is the Annual General Adjustment system which gives the bulk of public servants pay increases at least equal to the average movement in private sector wages. This system makes some sense when all private sector wages move at much the same rate, as they have in the last ten years. It makes a good deal less sense if there is greater dispersion in wage settlements in the private sector, as both the unions and employers have agreed would be desirable. To overcome this problem, and to give departmental heads more freedom, one approach might be to allow the wage and salary bill for each department to increase at the same rate as average private sector wages, and then to give the Permanent Head a good deal of freedom as to how that increase is allocated in the department. Some monitoring of benchmark positions in departments may also be appropriate, to ensure that state wages did not diverge inappropriately from the equivalent private sector wage (or overall remuneration package). Other mechanisms allowing greater freedom could also be devised.

The higher level of responsibility could also be matched by a more open system for appointing senior public servants to ensure that the best person for the job was appointed, regardless of whether or not he or she was presently a member of the public service. A system of three or five year contracts, renewable if performance has been satisfactory, could be implemented to allow for greater freedom. An Australian move in this direction has been reflected in a reclassification of the title of Permanent Head to Departmental Head.

The Process of Review

There appear to be two major options for the review process: the first is through the type of Cabinet Committee(s) outlined above, the second through a committee of Parliament. These options are not mutually exclusive. It would of course be appropriate for Cabinet Committees to review the progress of the department towards its goals at the time the management plan was reviewed. The Public Expenditure Committee of Parliament could also have a legitimate role in reviewing the performance of a department in meeting the goals set by the Government and in spending the money allocated by Parliament. The more open nature of the Public Expenditure Committee framework could also encourage better performance by public servants. The major change that might be necessary for this system to perform more effectively might be a requirement that the Minister responsible for the department also attend the Committee's hearings, so that Members could discuss the policy questions that they are not able to explore under the present system. The Public Expenditure Committee could then perform a role similar in some ways to that of a shareholders' meeting for a major public company.

Summary and Conclusion

This paper has suggested that some fundamental changes to the way the government machinery is organised may be appropriate if the goal of greater efficiency in the use of resources is to be met. Some of the changes, such as the introduction of detailed management plans in departments, could take a good deal of time to implement, and for this reason, and also because of the amount of resources that a detailed review of all government departments and agencies would take on an annual basis, other forms of expenditure planning and review will remain necessary.

However, changes to the Cabinet Committee structure could be implemented very quickly, and could provide an opportunity to examine in more detail the issues outlined in this paper.

We see developments along the lines outlined in this paper as being very important if the public service is to perform more effectively. A more coherent management system with clearer objectives for departments and staff, appropriate incentives, and a proper review mechanism could make an important contribution to the economic well-being of the country, given the size and importance of the public sector. Further papers setting out in more detail the options available could be prepared for consideration.

APPENDIX

STATE OWNED TRADING ENTERPRISES-SALE

Where after case by case examination it is clear that the non-commercial objectives can be achieved by means other than through State owned trading enterprises, gains can often be expected from selling ownership of an enterprise to the private sector. Because of transferable ownership, management in the private sector faces a response to its performance in the form of movements in the sharemarket price of the enterprise which affects its ability to raise further finance and exposes it to takeover. Other companies which perceive that the current management are not using the company's resources to the best advantage have an incentive to take it over at the depressed price, put the company's resources to a better use and gain the extra return. Hence, the ability to transfer ownership of a private firm creates a strong incentive for management to manage efficiently to avoid being taken over or displaced.

In the end, because control cannot be freely transferred under State ownership, the incentive for the ultimate owners (i.e. individual taxpayers) to monitor performance is removed and the incentive for managers to strive for maximum performance is thereby reduced. Because of the advantage of the incentives generated by private sector monitoring of performance, gains can be expected from selling an enterprise to the private sector, where other reasons for government ownership are not compelling.

Sale to the private sector would transfer ownership from the public in general (where no individual has the incentive to monitor performance) to owners who would have such incentives since their income would be linked to the efficiency of the enterprise. Under continuing State ownership there is always the problem that the control agencies which monitor performance may come to identify with those they supervise.

Through ownership of a trading enterprise the State has rights to income from developing certain of the nation's resources. Alternatively, by selling the enterprise, the State would realise in one lump sum an amount of equivalent value to the future income that would be expected from retaining ownership. Furthermore, to the extent that private sector ownership would relieve the enterprise of some constraints to economic efficiency, a premium above the present value of the future income steam could be expected. Thus the taxpayer would be as well or better off.

The sale of existing shares in organisations like Air New Zealand or Petrocorp is one way that the fiscal deficit can be financed in the short term. Financing the deficit in this way has some similarities to financing it by selling debt to the New Zealand public. Selling debt gives the lender a claim on the State in the future. Selling an enterprise gives the purchaser a claim to future income.

Chapter Fourteen

Meeting Government Objectives Through Intervention in the Private Sector: Regulation and Industry Assistance

Introduction

This chapter outlines a framework for evaluating government intervention in the private sector. The fundamental criterion identified is that the benefits of intervening to modify the outcomes that could be expected through private initiatives should exceed the costs in the widest sense of raising national welfare by improvements in efficiency and equity. The point is made that this kind of approach in the private as well as the public sector is an important part of the process of improving the effectiveness of broader tools of economic management and thus economic performance itself. Four examples from the domestic economy are used to illustrate briefly the implications for policy arising from these principles of intervention. Finally, an approach to policy in the tradeable goods and services sector is outlined in the light of a number of decisions which are pending in this area. While the details of policy are likely to be affected by the desire to achieve an improved fiscal situation and by decisions which may be made with respect to exchange rate policy, the key to progress in this area will depend principally on the pace of reform of import protection.

I FRAMEWORK FOR CONSIDERING INTERVENTION

There are many ways to categorise government intervention in the private sector. One common approach is to regard it as a form of interference in the free operation of an otherwise unfettered market. Viewed in this way, an intervention can be classified according to its location in a range varying from "persuasion" or "advice" at one end of the spectrum to virtual complete control (as in sectors of the command economies) at the other. This approach focusses attention on the question: "should the Government intervene?".

An alternative and more useful approach flows from the perspective that transactions between individuals and organisations are based on sets of rights and an institutional framework (including, for example, contractual law) which do not have an inherent existence of their own but emerge and change in response to pressures of social consensus and political choice. The most obvious body to fulfil the role of "setting the rules of the game" and ensuring that they are followed is the Government. In a sense then, all markets can be thought of as having a label attached reading "made by Government". Viewed in this way, it does not make sense to treat "free" markets as being at one end of a continuum which ranges from no government involvement to complete government control. Since a decision not to interfere with the operation of an existing market is then equivalent to allowing a given set of interventions to stand, it is more useful to consider the question "what set of interventions is most appropriate?" than to attempt to answer those of the form "should the Government intervene?" In any particular intervention decision, therefore, the extent to which market forces are utilised is a matter related primarily to the process by which an objective may be achieved rather than an objective in itself.

Defining the Scope of the Market

Few, if any, societies leave the entire range of "economic" activity to be determined purely by market outcomes. A feature of what are generally regarded as civilized societies is that certain areas are reserved as the "domain of rights and duties". For example, the direct marketing of civil or electoral rights (buying and selling rights to vote), or of the duty to obey the law, while perfectly conceivable as types of market transaction, are usually regarded as being unacceptable. These are areas of human activity in which equality is given a dominant weighting over other social objectives. However, there are areas in which the achievement of equality (or more broadly equity) may be regarded as being subservient to other considerations such as efficiency, or where gains in one must be traded-off against losses in the other.

Efficiency is concerned with achieving the greatest level of national income for a given quantum of resources. However, there is no reason to presume that the resulting distribution of income and wealth will be regarded as socially desirable, nor that society would be unwilling to trade a reduction in aggregate income for a more equitable outcome. (However, it should be noted that many decisions facing society may involve improvements in both efficiency and equity.) Some government action to redistribute income in favour of less advantaged members of the community may strengthen social consensus and democratic processes and allow incentives to the improvement of individual welfare to operate with less resistance. Reflecting these social equity and efficiency objectives, a government may wish to add to, subtract from, or change a given set of interventions.

It is in those areas where efficiency concerns are not dominated by arguments favouring alternative goals (including those in which an equity/efficiency trade-off exists) that use of the market mechanism may offer some advantages. It permits individuals and organisations voluntarily to engage in exchanges to the benefit of each participant in a transaction. By rewarding "good" decisions with profits, and penalising "bad" choices with losses, the system provides an incentive structure which, in most cases, can be expected to generate an efficient use of resources. It is also a highly efficient method of generating and passing on information in that each transaction acts as a signal to those involved and forms the basis of further decisions. Only the most essential information is passed on, and only to those concerned. On the other hand, centralised control of economic processes necessitates the acquiring of large amounts of detailed information at considerable cost in an economy as complex as New Zealand's, Fundamentally, the market's attractiveness lies in its ability to align private incentives with social goals. A heavy reliance on controls may result in the coercive power of the government being stretched beyond its limits.

While market mechanisms do have some advantages in efficiency terms, there are a number of situations in which they may fail to produce socially appropriate outcomes on efficiency as well as equity grounds. For example, certain goods and services are essentially of a public nature and would not be produced in the quantities society as a whole considers desirable if left to private initiatives. Thus, in areas such as law and order, defence or even street lighting, the appropriate level of government (central, regional or local) is the logical provider. Beyond pure "public goods", society may prefer a level of output different from that which the market yields. For example, this divergence of social from private costs and benefits is frequently quoted as a reason for government intervention to achieve a higher level of investment in basic research and development or a lower level of pollution, and as a rationale for ensuring that "natural monopolies" produce the socially appropriate level of output.

Even in these cases, however, there may be a case for selecting a market-based intervention in preference to the use of strict regulation. This arises because many decisions are of a continuous type rather than of a discrete "either/or" form. For example, a wide range of pollution levels arising from certain types of discharge into waterways may be regarded as being acceptable. In such situations, a pollution tax (charging dischargers according to their level of pollution) may be the most efficient intervention since acceptable purity levels could be achieved by action from those for whom it was least costly to reduce their levels of effluent. On the other hand, for highly toxic pollutants, miniscule amounts of which would represent unacceptable levels, regulations totally prohibiting their discharge clearly have an advantage over measures based on the price mechanism.

Evaluating Interventions

The fundamental criterion for determining whether or not a particular government intervention should be instituted or withdrawn, therefore, is that the action would result in a socially preferable outcome. It is nearly always possible to argue that an altered set of government interventions or market signals would produce benefits for some individual or groups, but these cannot be evaluated in isolation from the additional costs involved. Since government intervention is not without its costs, identification of a potential improvement to the economic position of one group or sector, as opposed to the welfare of the community at large, is not itself sufficient to justify action by the government. These costs of government intervention include those of a more direct form (administrative and compliance costs and the resources consumed in lobbying activities) and broader economic costs that flow from economic distortions (unintended by-product effects) which are almost always associated with intervention. These wider costs flow from the observation that given the level of resources available to a community, the granting of assistance or special privileges to one activity or group can only be achieved by penalising others. This feature is readily recognisable when the assistance is provided through a taxpayer funded subsidy, but nevertheless occurs when fiscal transfers are not involved. For example, restrictions on the availability of imported motor cars may raise the price of cars to purchasers and, by the expansion of local car production which uses productive resources of capital, labour and management skill, deny the use or raise the cost of those resources to other activities. The effect may be to shift New Zealand's pattern of industry development away from one which reflects the best use of our resources (at a cost to community income) and to switch consumers' spending patterns away from their preferred choices. This focusses attention on the need to select the appropriate form and level of interventions and to ensure that the impact of an intervention is as neutral as possible (to the extent consistent with the objective concerned) so that associated costs can be kept to a minimum.

The general approach that a policy instrument should be directed as closely as possible to the purpose in hand and that the more direct policy devices are usually preferable to those which are less direct is a theme which runs through much evaluation of government interventions. (Like all generalisations it is subject to qualifications, such as when the administrative costs of direct instruments are high.) An example will help to illustrate the point. Suppose that an objective of policy is to increase employment in manufacturing (at the expense of other sectors-leaving aside the question of whether this is a desirable objective in the first place). One approach would be to apply tariffs or import restrictions on manufactured products. While this might have the effect of encouraging manufacturing output and employment, it creates at least three separate distortions: it encourages capital as well as labour to be drawn into manufacturing, it raises prices to consumers of import competing manufactures and it creates a home market bias in production (toward import substitutes and away from exports). An alternative would be to apply both an import tariff and an export subsidy. This would remove the home market bias but retain the other two by-product distortions. A production (value-added) subsidy would be superior to trade restrictions in that it would avoid raising the price of manufactures to consumers. The most direct approach of all would be an appropriate subsidy on manufacturing employment, financed in the least distortionary way. It is also clear that each of these approaches would impose costs on other groups (taxpayers, consumers, consuming industries or other producers) and hence involve lower levels of employment in other parts of the economy.

The Macroeconomic Policy Connection

Many interventions used by the government affect the efficiency of other instruments available for government action. This extends to the area of macroeconomic policy. For example, industry assistance provided by means of fiscal subsidies requires financing through either increased revenue or increased borrowing. If the former is chosen the strains already imposed on fiscal policy may be exacerbated, and further incentive and disincentive effects created. As discussed in the chapter on exchange rate policy, regulations restricting foreign exchange transactions hinder the adjustment of both the nominal exchange rate and interest rates to changes in economic circumstances. In addition, a cost-plus mentality, fed by cost-accommodating protective structures as well as other interventions in commodity and factor markets, reduces the effectiveness of the exchange rate as a means of obtaining shifts in relative prices (particularly shifts in favour of exports). The monetary policy chapter argues that financial regulations, including interest rate controls, may make the achievement of monetary control difficult if not impossible. More generally, a less regulated economy is typically more flexible and responsive than one in which controls are widespread and where the costs of both gaining information and achieving change may be considerable. These features enhance the effectiveness of a wide range of instruments and ease the exercise of economic management.

II INTERVENTION IN SECTORS PRODUCING NON-TRADEABLES

The broad approach outlined above can be applied to a wide range of government interventions and to different sectors in the economy. In particular, government assistance to those goods and services commonly thought of as entering international trade can be evaluated in terms of the form and level of interventions used, and the extent to which they are neutral in their impact beyond the objective being served. Prior to examining this area, reference is made to government intervention in four areas typically thought of as falling within the non-tradeables[1] sector : the transport industry, the financial sector, energy and the marketing of primary exports. These examples are chosen to illustrate the applicability of the principles developed to a wide range of interventions, but the list is not intended to be complete. For example, government interventions affect a much wider range of factors influencing the conduct of international trade than is outlined by reference to export marketing. These include a large array of activities often grouped under the heading of "trade policy" or "trade promotion" such as bilateral preference agreements, counter purchase arrangements and export insurance. While many of these interventions have a rationale of their own, they should still be evaluated in terms of the economic criteria described in the previous section.

Three forms of intervention are encountered frequently:

a intervention by assistance (utilising a variety of instruments available to the government, such as fiscal subsidies and taxes, quantitative restrictions on the extent of competition, and tariffs as a means of raising or lowering the returns to different activities);

b intervention through regulation (requiring activities to be performed in a certain manner or under certain constraints. For example, producer boards are given control of the exporting and overseas marketing of certain of our primary products);

c intervention via ownership (going beyond possible public sector responsibility for provision to partial or complete public production. The Forest Service, the Housing Corporation and the Rural Bank all provide examples of this type of intervention).

Most of the interventions referred to below fall into the assistance and regulation categories. There are some references to government owned enterprises which are discussed more fully in a separate paper.

The Transport Industry

Many forms of economic regulation of the transport sector have been substantially reduced over the last three years with the liberalisation of transport licensing. The 150 km limit on road transport has been removed (although there is a temporary long distance fee) and quantitative licensing of road transport has been lifted in favour of a qualitative system. Domestic aviation has been liberalised in the same manner. On the other hand, urban transport provides an example of an area of economic activity where government involvement has been considered desirable in the interests of achieving a more efficient system, because the costs and benefits of individual transport choices in that market are not always appropriately allocated. One important form of government involvement in the sector is the funding of the Urban Transport Council with a budget of $58.1 million for 1984/85. The policy framework within which the Council operates is aimed at removing economic distortions between modes and between regions, and its ability to provide assistance has been put on a more rational and equitable footing. Government intervention via ownership has also been liberalised with the former Railways Department becoming a Corporation in April 1982, with its own Act and Board of Directors. This has freed Railways from detailed Ministerial control and placed uneconomic "social" services costing $40 million per annum on an explicit subsidy basis.

These reductions in intervention through deregulation and arms length control of government owned enterprises are promoting cost improvements and new attitudes to management and work practices in an important sector of the economy. The benefits of an improved pattern of use of urban land and transport resources in the major centres will also be significant over time. However, further steps are likely to be needed to fulfil the objectives suggested in this paper, including:

a further steps towards a neutral competitive environment between the main transport modes, notably full cost recovery for government-provided infrastructure through road user charges (and airways dues) and the removal of tax advantages and remaining forms of special protection applying to the Railways Corporation;

b a review of local authority financing arrangements to determine whether they are consistent with the increasing responsibilities being assumed for urban transport;

c more rigorous scrutiny of the case for "social" service payments to the Railways Corporation, which would probably lead to substantial reductions; and

d an examination of other areas of transport regulation, in particular taxis, ports, and international airfares.

The Financial Sector

The present financial sector is subject to widespread interventions. These include controls on interest rates (lending and deposit rates generally, as well as separate regulations on mortgage lending) and guidelines for lending growth rates across most institutions backed up by a marginal ratio requirement on finance companies, all of which are of relatively recent origin. The underlying environment in which financial institutions operate is characterised by a number of institutional types (e.g. trading banks, finance houses, insurance companies) which are defined largely by accumulated statute and regulation of a more or less ad hoc nature. These institutional categories are subject to interventions which confer a range of competitive advantages and disadvantages on each compared to others. While specialisation is as likely to occur in the supply of financial services as in any other area of the economy, the types of activity currently undertaken are often determined more by the regulatory environment than by the particular expertise of the institution itself. Examples of existing interventions include the "30 day rule", preventing the payment of interest on trading bank deposits of less than 30 days; the trading banks' collective agreement not to pay interest on cheque accounts; the 3 percent restriction on the interest on ordinary savings accounts; an extensive range of public sector security ratios applied to major financial institutions; and a range of exchange control regulations which, amongst other things, limit the opportunities for institutions to spread risk and hedge against liquidity fluctuations by holding foreign exchange.

Controls and interventions of this type can severely impede the role of the financial market in mobiising funds and acting as an efficient channel of intermediation between savers and borrowers. Suppressed interest rates may reduce savings efforts and alter their form, and reduce the incomes of net saving groups (which includes the household sector as a whole). If interest rate controls are binding, they necessarily imply non-price rationing of credit. If credit is not allocated on the basis of the borrowers' willingness to pay the price (the interest rate), then it must be rationed in some other way. Administrative methods of allocation are likely to channel scarce capital resources in less preferred directions. Such rationing is also likely to have significant distributional effects in terms of the groups which will be able to get access to the rationed credit. In particular, because lending interest rates are usually higher the greater is the perceived risk of the loan, lending rate controls will reduce the availability of credit for high risk investments (e.g. venture capital) and for loans to high risk groups-this latter would include those on lower incomes and/or having fewer other assets available as collateral. In other words, controlled interest rates will tend to adversely affect small savers and less wealthy borrowers, including small businesses, and hence have detrimental effects on savings and investment. This is a good example of an area where a more liberal environment would enhance the prospects of achieving both improved efficiency and equity outcomes.

The Energy Industry

The State owned energy producers (New Zealand Electricity, State Coal Mines, geothermal, New Zealand Synthetic Fuels Corporation and Petrocorp) are major industrial undertakings with a high capital intensity and a pervasive influence on the domestic economy. The prices of virtually all forms of energy are determined by the Government. In addition a number of areas (electrical supply authorities, gas reticulation, motor spirit distribution) are tightly controlled by legislation.

Ownership of NZE and SCM has been characterised by both organisations receiving considerable financial advantages regarding cost and maturity of debt, no requirement to pay dividends, and no requirement by NZE to pay tax. Neither Organisation has clear financial objectives or measures of performance (although these are being developed at present). The result has been substantial underpricing of these fuels and an effective subsidy (amounting to several hundred million dollars per annum) to consumers. Low prices and the lack of clear objectives not only remove a major incentive to operate efficiently but also act as a major barrier for alternative private sector sources of supply with a lower cost of production. Examples include conservation, privately generated electricity and private coal mines. Price control on motor spirits and reticulated gas discourages competition that would allow a cheaper or higher quality service to be provided. The pricing' policies and effects of government ownership at present do not encourage competition: they provide compensation for cost plus or inefficient operation, and lead to more expenditure in the sector than would be justified on economic grounds.

Marketing of Primary Exports

As a separate chapter discusses at greater length, the Government intervenes in the export arrangements of most of New Zealand's primary products through the provision by statute of compulsory powers to producer boards and authorities. These powers include product acquisition, export licensing, the setting of standards, and the imposition of levies. Such powers have long existed in the case of dairy and meat products and for apples and pears. Similar powers have recently been extended to, or proposed for, newer forms of primary products such as horticulture, game, and goat fibre.

The main argument for limiting competition among exporters is that total returns will be higher if New Zealand exporters do not compete with each other in overseas markets (the "weak selling" argument). In fact there are few if any situations in which New Zealand exporters can raise returns in the long term by limiting competition between them. Further, limiting the number of exporters, or imposing quality or other restrictions, can similarly erode export performance by discouraging initiative in seeking new forms of product presentation, new markets, new service packages and other forms of innovation.

III INTERVENTION IN THE TRADEABLES SECTOR

The main interventions in the tradeables sector include assistance provided through tariffs, import licensing, export incentive schemes and subsidies of various types on primary sector exports. The attention given to these interventions reflects the fact that a number of decisions are pending in this area. These arise as a consequence of recent discussions with manufacturing, primary sector and other interested organisations and because of the review of export assistance which must be brought to a conclusion.

Existing Assistance Structure

In contrast to the principles outlined in the introductory section of this paper, the existing structure of assistance to tradeable production in New Zealand is notable for its high level, its lack of neutrality and the wide variety of forms of intervention employed. This reflects the history of ad hoc responses to expressed or perceived "needs" of industry at various times.

The principal forms of import protection are import licensing and tariffs. The former, introduced in 1938 for balance of payments reasons, is now seen in an essentially protective light. While the scope of licensing has been reduced at various intervals since 1950, until relatively recently the emphasis has been on removing licensing on goods not made in New Zealand or on goods used as inputs in local production which itself is protected by licensing. The result has been the provision of increasing levels of net assistance to local final goods production with a growing bias toward lower levels of domestic content (i.e. against local production of intermediate inputs). It is not clear that average levels of manufacturing assistance have consequently declined. There is some evidence, for example, that assistance to the New Zealand textile industry has increased overall in recent years even though some initial market-opening steps have been taken. Further, the very high protection provided by import licensing is often backed up by high levels of tariff protection. On the basis of tariffs alone, New Zealand's secondary industry would be the most highly protected in the OECD and in addition we are the only advanced country to maintain *comprehensive* quantitative controls on imports of manufactures.

Even more significantly, the level of assistance provided to import substitutes is highly uneven. One of the effects of instruments such as import licensing is to automatically provide higher assistance which validates, to a large extent, any declines in competitiveness brought about by changes in technology, tastes, efficiency or other factors. Thus, while licensing may provide little assistance above the tariff in a number of cases, in others it enables local producers to obtain a price up to several hundred percent in excess of imported equivalents. By contrast, products not traditionally manufactured in New Zealand (for example, computers), and in particular those which are used as inputs into industrial processes, tend not to be protected by licensing and frequently do not attract tariffs either. This also affects new or potential industries.

Because of their cost-raising effects, the high levels of assistance provided to import substituting activities has lead to “compensatory” assistance being granted to the export sector and other disadvantaged activities. These disadvantages arise through the direct effects of protection in raising the prices of inputs, through the competitive bidding up of the price of labour and other resources, by the action of protection in permitting an appreciation of the exchange rate vis-a-vis what it would otherwise be, and because higher-priced importable goods may absorb a larger share of consumer expenditure, thus reducing demand for other goods. For these reasons, import protection is often described as a “tax” on exports (and other lightly assisted activities).

The bulk of assistance to “non-traditional” (manufactured and horticultural) exports is provided through performance-based incentive schemes, principally the Export Performance Taxation Incentive. However, a number of other schemes also apply and, despite some efforts at achieving uniformity, the general impression, confirmed by the Syntec study on industry assistance received earlier this year, is once again of highly disparate rates of assistance. In the primary sector, assistance is provided in a wide variety of ways which can be broadly grouped as assistance to outputs (e.g. supplementary minimum prices), assistance affecting the returns to value-adding factors (e.g. interest rate concessions) and assistance to material inputs (e.g. fertiliser subsidies). The Syntec Study confirmed that some very high rates of assistance can be found in the primary sector and that these are highly variable between activities and have grown over time, principally as a result of SMPs.

The Need for Change

The basic impact of an assistance structure with such a marked lack of neutrality is to distort decisions made by economic agents, whether they be consumers, consuming industries, or producers, away from the set of choices which would be made on the basis of less distorted market (or indeed any other set of socially desirable) incentives. The result is a lower level of national income and welfare than would be the case if prices reflected more truly the value to the community of the resources involved. The disparate levels of assistance also have equity effects which are unlikely to coincide with a socially desired distribution of income and wealth.

Beyond the losses resulting from a misallocation of resources are dynamic effects which international experience and research suggests are likely to be both pervasive and substantially more costly. Highly assisted activities, especially those protected by instruments such as import licensing, have the scope denied to those not sheltered from international competition to pass on increased costs, limited only by what the local market will bear and local competition allow. With minimum international competition, pressures to keep costs and prices down and to improve productivity and efficiency are greatly reduced. Similarly, the stimulus to innovate, to respond to technological change and to deal flexibly with variations in the pattern of market demand is also lowered. [2] In addition, the reliance of protected industries on a small and static local market, while attempting to cater to a limited extent for the range of qualities and designs domestic consumers expect, reduces their ability to specialise, yet specialisation is a key technique for increasing efficiency and lowering costs.

The lack of responsiveness, reduced incentives to change, and poor allocation of resources associated with high and uneven rates of assistance have been key contributors to our poor economic performance and lack of growth in recent years (although other factors have also had an important influence). Probably the best impression of the overall costs of a protective and inward-looking development strategy can be gained by comparing the growth rates of countries which have chosen such strategies with those which have chosen to promote more open and competitive economies. A recent World Bank comparison of the performance in the 1970s of a group of developing countries with low price distortions (of which distortions due to trade restrictions were among the most important) with a group of countries with high price distortions indicated a difference in growth rates of 4 percent per annum between the two groups. It is also notable that the outward-looking economies with the fastest growth rates were also those which adjusted more easily to external shocks.

The particular forms of assistance utilised in New Zealand involve a high fiscal cost. The annual fiscal cost of the EPTI is currently around $300 million while the basic cost of SMPs was $350 million in 1983/84. When all relevant outlays on support to industry are accounted for, the total involved is much larger. On the other hand, the reliance on import licensing, the prohibitive effect of high tariffs and other trade restricting measures, and the practice of permitting the duty free entry of most industrial requirements not produced locally have all combined to make New Zealand's relative share of revenue from protection one of the lowest in the world. A lower, more neutral assistance structure would carry significant fiscal benefits.

That an improvement in the fiscal situation over the medium term is an important element in generating an improved economic performance has been argued elsewhere in this brief. While reduced budgetary support to industry has the potential to contribute to this, industry itself would benefit in turn. The prospects for inflation control and reduced costs of capital to industry would be enhanced by a lower fiscal deficit. Macroeconomic (fiscal, monetary and exchange rate) policy has a far more fundamental impact on the level of costs and prices, and thus competitiveness, than do many specific forms of industry assistance.

New Zealand has a number of international obligations which impinge on our continued ability to provide assistance to exports. Under the ANZCERT Agreement, New Zealand is obliged to phase out its performance-based export incentives on exports to Australia between 1985 and 1987. New Zealand has also undertaken to bring various export incentives (including the EPTI) into conformity with the GATT Code on Subsidies and Countervailing Duties "within reasonable time" and it is the expectation of the United States that this will occur by 31 March 1985. The problem for economic policy is that the phasing out of such assistance could result in a widening "assistance gap" against exporting unless more rapid action is taken on the import protection front.

Current State of Assistance Reform

In line with the principles outlined above and the priorities for reform identified in the Syntec study (a relevant extract is attached as an Appendix) emphasis has been given to initiating reforms aimed at changing the form, level and lack of neutrality in the existing assistance structure. Decisions have been taken on a wide range of industry studies, and although a number of these will be coming up for review over the next few years, many are on an automatic "licensing to tariffs" track over periods of typically five or six years. The emphasis has been on a very gradual rate of change, and even those traditionally regarded as "sensitive" industries (such as textiles) do not appear to have experienced marked difficulty in adjusting. While progress in these areas may continue to meet with some resistance, it will be important to maintain the momentum of change, given that many of these industries are in aggregate the most highly assisted and the largest contributors to disparities in assistance. A separate report will summarise the current position in the industry studies programme.

In order to pursue the goals of assistance reform in activities outside those subject to industry plans, discussions were initiated last year with the New Zealand Manufacturers' Federation, aimed at developing arrangements for the gradual switch from import licensing to tariffs as the prime means of protection. The proposals involve an initial expansion of import licence availability, basically through tendering, equivalent to 5 percent of domestic production less exports of the goods concerned, with additional allocations of between 2.5 percent and 5 percent of production levels in each subsequent year (the precise expansion factor depending primarily on tender premia). The motivation for this expansion factor rule is to ensure that a somewhat faster rate of adjustment to import competition is faced by the most highly assisted ("tall poppy") industries as revealed by the size of tender premia. When tender premia reach defined low levels, an automatic switch to licence on demand, followed by licence exemption, will be made. The position reached is that the Manufacturers' Federation has agreed to the proposals subject to additional transitional assistance being made available. Further discussions have been scheduled to examine the nature of the criteria to be applied in determining long term rates of assistance to be accorded through tariffs.

On the export assistance side, the broad conclusions of the review are that even if it were considered desirable to find a replacement for the existing schemes, there is in any event no suitable alternative that would be as neutral in its impact while still remaining acceptable to our trading partners. The problem for economic policy, therefore, is to avoid the assistance gap (and the resource misallocation and consequent effects on national income) that would emerge as export assistance is phased down while import protection remains high. It is apparent that the only satisfactory solution to this problem is the acceleration of reforms to import protection.

Reforms are also indicated for a number of other forms of export assistance (for example in the promotional area) but some of these need to be considered in terms of motivations for government intervention other than protection compensation.

A parallel approach is being followed in the agricultural area, with emphasis being placed on removing or reforming those forms of assistance with the greatest associated distortions and on reducing the disparities in assistance also prevalent in this area. Agreement has been reached with the producer boards to terminate the SMP scheme with final lump sum payments in the 1984/85 seasons equivalent to the subsidy which would have been paid if the scheme had been continued. The precise extent of this subsidy will depend principally on prices realised for wool and sheepmeats. On the basis of expected prices and the present exchange rate it is currently expected that $166 million would fall due for payment in 1984/85 and $76 million in 1985/86. In addition, final payments of $177 million for the 1983/84 season fall due in the 1984/85 fiscal year. Last year's agreement to move the dairy industry account (the Dairy Board's current account) to commercial rates of interest put all three of the largest producer boards on the same footing as to the financing of stock increases. The Meat and Wool Boards' "reserve" accounts have also been put on a commercial basis and discussions will take place later in 1984 to bring the Dairy Industry Reserve Account into line.

Reviewing the Approach to Policy

It is now clear that substantially better economic performance in New Zealand would be promoted by-indeed is dependent upon-major and progressive reforms to the system of import protection, and that economic performance would also be aided by the budgetary savings which a trade liberalisation programme would facilitate. The important point to note is that the decisions taken on the protection side will, in large measure, determine the rate at which fiscal assistance to non-traditional exports should be phased down and the future level and shape of assistance arrangements applying to the primary sector.

A further linkage should be made between industry assistance reform and exchange rate policy. It was argued above that changes in certain forms of industry assistance would act to improve the effectiveness of exchange rate policy. On the other hand, a significant change in the exchange rate and modifications to the future management of macroeconomic policy, by maintaining international competitiveness as trade restrictions and subsidies are reduced, have a potential contribution to make to the process of assistance reform. What a devaluation would not do, however, is address in any fundamental way the problem of an increasing assistance bias toward import competing activities subject to high rates of protection if export assistance were reduced. This is because, to the extent that a devaluation was successful in achieving a permanent shift in the relative prices of traded and non-traded goods, it would in principle benefit import substituting and export oriented activities equally.

Approaches to exchange rate management discussed separately are nevertheless highly relevant to the process of easing the reliance of industry on the border inventions of trade restrictions and subsidies. Sound macroeconomic policies will be needed to maintain-and indeed enhance-the competitive position of affected producers as the border interventions are reduced, and the effective conduct of such policies would be certain to promote a climate of opinion more favourable to the acceleration of assistance reductions. Moreover, one of the concerns frequently expressed in connection with trade liberalisation programmes is that short run adjustment costs may be considerable given that it may take time for resources shed by activities subject to assistance changes to be absorbed by those which are expanding. A significant devaluation at an early stage of the liberalisation programme may ease that adjustment process, since the more efficient activities can be expected to be responding to new incentives to expand by the time resources are being shed elsewhere. Finally, despite its neutrality between import competing and export activities, a lower exchange rate, through its interaction with certain assistance instruments, could provide a route by which high rates of assistance to affected activities could be lowered. This is explored further in the following sections.

Import Protection Reform

It was stated above that the pace of import protection reform will have a major influence on the rate of change that can be achieved in assistance to other tradeable activities. There are a wide variety of ways in which the current programme of reforms could be accelerated and improved. The list below gives a number of examples (not necessarily mutually exclusive) which take as a starting point the set of reforms already agreed:

a *A one-off up front licence expansion associated with a devaluation*

While a devaluation does not affect the assistance provided by ad valorem tariffs, this is not the case for assistance provided by licensing, although the effect is not unambiguously in one direction. However, the effect of devaluation in reducing the purchasing power of licence holdings and improving the competitive position of the local industry (typically highly assisted by licensing) will generally result in an expansion in output and draw some new resources into inefficient areas of production. In principle, a technical adjustment could be made to the licence allocation levels to remove this effect, but an approach based on an across-the-board increase in licence allocations of, say, 5–10 percent of the domestic market or domestic production would have the potential to make a greater contribution to the assistance reform process. This would have the effect of expanding licence availability by a relatively greater proportion in areas where few licences are currently available. These are typically the most highly protected. The case for a devaluation-related adjustment for items subject to industry plans should also be considered.

b *Variations to the rules for general licence liberalisation procedures agreed to in discussion with the Manufacturers' Federation*

Following an initial allocation of additional licences in association with a devaluation, on-going procedures for liberalisation could be reviewed. Instead of the proposed annual increments of between 2.5 percent and 5 percent of domestic production (less exports) the rates could be increased to, say, a minimum of 5 percent of the market with higher rates for taller poppy items as revealed by tender premia. As well, the premium cut-off point determining the faster rate of liberalisation in subsequent years could be set at say 20 percent and that for movement to licence exemption raised from 7.5 percent to say 10 percent. This kind of approach would have the advantage of ensuring a gain in the pace of reform beyond the current year, but amendments to the current agreement would be required.

c *Combinations of the two previous approaches*

Under the agreement with the Manufacturers' Federation, the first round of tenders for some products are expected to occur in September or October with others not occurring until later. A "one-off" devaluation adjustment approach could be combined in various ways with the initial round of licence allocations under the agreement.

d *Imposition **of** a cut-of date for import licensing*

One of the uncertainties surrounding the current arrangements is that no date applies beyond which licensing protection will not be available. A cut-off of this type (similar to the arrangement for import licensing under ANZCERTA), if perceived as being firm, would have the potential to stimulate a faster rate of adjustment among the most highly assisted industries in order to avoid the "sharp edge" of sudden licence removal. In public commentary on the current package, a five year period for moving from licensing to tariffs has been mentioned by industry representatives as an implicit indicative timetable.

e *Long-term tariff reform*

Agreement has yet to be reached on the basis on which longer term assistance, in particular tariff rates, would be set under the protection reform proposals. In the longer run this should be by reference to the sorts of principles outlined above (especially greater neutrality) but to date some emphasis has been given to adjustment considerations (often referred to by industry as "needs") while licensing still applies. There could be advantages in considering an earlier application of long term tariff rates under the umbrella of licensing, since this would enhance the signals given as to the direction of the reforms and provide for a smoother adjustment path (under licence rather than tariff phasing) for the activities concerned.

It will be fundamental to the efficiency of any such global approach that the liberalisation programmes currently in train for other industries are at least maintained and that consistent treatment is applied at any points where separate consideration of them is required. If highly protected activities were excluded from further adjustment pressure, they would retain or attract resources at the expense of more efficient activities and the basis of the whole approach to reform would be invalidated (disparities could become worse). In particular, it will be important in the impending review of the textile industry that a rate of exposure to import competition is decided for the highly assisted branches of this industry which is rather more rapid than for manufacturing industry on average. Similarly an approach which is consistent with these principles will need to be applied to motor vehicles, both in reviewing the recent decisions and at the end of the planned testing period. It might not, however, in the short term be necessary to foresee a predetermined end to import licensing for those parts of these industries which will face the greatest adjustment difficulties.

The method of allocating most incremental licence amounts would be by tender, as recognised in the summit discussions. Tendering also produces some revenue for the government in a non-distorting way—some $100-200 million in combined tariff and tender premium revenue could be yielded by the programme outlined. Changes in the exchange rate will also affect tariff and tendering revenue, but due to self-cancelling features this effect may not be large.

Export Assistance Reform

As outlined above, the immediate constraints on the continued provision of the principal forms of export assistance are the expectation of the United States that relevant schemes will be brought into conformity with the GATT Code on Subsidies and Countervailing Duties by 31 March 1985 and the pending phase-out of performance-based schemes on exports to Australia under the ANZCERT Agreement. The implication of a negative United States reaction to a failure by New Zealand to meet their expectation would be the potential withdrawal of the injury test in countervailing duty cases against our exports. This could have substantial implications for our trade.

In practice, it is likely to prove difficult to gain United States acceptance of a move to extend the EPTI beyond the period envisaged for exports to Australia under ANZCERT (termination in 1987). Given that the rate of phase-out needs to be determined with reference to the pace of import protection reforms, the basic options revolve around the ANZCERT formula or possibly faster.

The fiscal impact of a phase out of the EPTI commencing in 1985 would not be feit until the 1986/87 fiscal year because of the cash flow effects of the business tax system. On the basis of the estimated current loss to revenue, the full fiscal savings would eventually amount to $300 million per annum. Additional, but much smaller, savings could be generated by the phasing out or reform of a number of other schemes. Adjustment to and acceptance of the phase out could be enhanced by exchange rate action and supportive macroeconomic policy and by consideration of a number of requests made by Manfed and other groups (for example progress on business and indirect tax reform, and talks on economic management issues). In Treasury's view, however, no case has been established for alternative forms of fiscal assistance, particularly in the context of a general economic strategy of the type suggested in this set of papers. It would be necessary to give consideration to the timing of any announcement on export assistance; a more positive public response from the United States' Administration could be expected following the elections there, although a more substantive constraint is likely to be US desires to avoid the risk of setting precedents in their disputes with other countries. On the other hand, public expectations of an imminent announcement, and possible moves on the exchange rate front, may militate in favour of an earlier announcement.

Agricultural Assistance Reform

Like much of the assistance provided to non-traditional export activities, the basic rationale for agricultural assistance lies in the compensation for the disadvantages imposed by protection. The rate of reform in this area, therefore, also needs to be considered in the context of the pace considered appropriate for protection reform.

Nonetheless, it is anticipated that a currency movement in excess of 15 percent before October 1984 would remove the requirement to pay SMPs, or their lump sum equivalent, on all products except for mutton. A devaluation after 1 October 1984, without renegotiating the agreement with the Meat Board, would not achieve any savings in the lump sum payment to the Meat Board. Given that reforms of producer board concessional interest arrangements are also in train, a judgement would need to be made as to whether any further reforms to current forms of assistance would be desirable in the near future. The review of assistance to agriculture, agreed with the producer boards, will need to take into account likely progress on protection reform. It would, however, be desirable to keep a tight control on the lending activities of the Rural Bank and consider possible reforms to its operation on the basis of establishing a more competitively neutral environment for rural finance.

The fiscal savings from complete termination of the SMP scheme depend on projected future minimum price levels and market returns in domestic currency units. Current payments to farmers are in excess of $200 million per annum.

IV SUMMARY

This paper has attempted to establish a framework for the consideration of government intervention in the private sector. It is argued that the fundamental criterion for evaluation is that of social benefits exceeding net social costs, each defined in the widest possible context. This condition is more likely to be achieved if interventions are carefully selected, appropriately targetted, neutral in their impact and have the minimum associated distortions. The framework can be used to evaluate current interventions and market mechanisms in both the tradeables and non-tradeables sectors. The argument has been advanced that there is considerable scope for continuing reform in the non-tradeables area.

With respect to tradeables, an acceleration in the pace of import protection reform would appear desirable. This could be achieved in a number of ways on the basis of existing or proposed arrangements. The primary objective must be to promote a more neutral assistance environment, which can only be satisfactorily achieved through a "tops down" approach to reducing high rates of assistance, not the "bottoms up" or compensation approach which has often been attempted in New Zealand in the past. A significant devaluation and changes in exchange rate management have the potential to contribute to this process. The rate of change in import protection arrangements will be the key variable in determining how rapidly reforms can be pursued in other areas of assistance to tradeables. The basic options with respect to performance-based export incentives revolve around a phase-out along the ANZCERTA timetable (1985–1987) or possibly faster. Exchange rate changes would present an opportunity to remove or substantially reduce SMP or substitute payments and to continue other reforms in the agricultural area.

As assistance reform proceeds, national income gains should flow from the improved allocation of resources which result. More substantial benefits could be expected from the emergence of a more flexible, responsive and internationally competitive economy. In this sense, assistance reform can be seen as part of an integrated approach to economic management. A more flexible economy would enhance the effectiveness of other economic instruments available to the Government and the opportunity presented by assistance reform to obtain substantial improvements in the fiscal situation would act to magnify these effects.

Footnotes

[1] The terms "tradeable" and "non-tradeable" tend to be used in a variety of ways and the classification of goods thus becomes a matter of interpretation. Non-tradeables are, of course, defined to exclude tradeables. Essentially the idea is that a commodity is tradeable if its domestic price is limited, in some proximate fashion, by the price that could be obtained overseas if it is an exportable, or, if importable, by the (tariff inclusive) price for which close foreign substitutes could be obtained for local sale. Thus, for example, when quality differences and variations in condition of supply are allowed for, the ability of local producers of, say, infants' clothing to raise their prices is limited by the tariff inclusive landed prices at which imports can be sourced. On the other hand, the price of haircuts is not usually thought of as being constrained by such factors (although even here some form of international trading is conceivable). It should be noted that some forms of intervention such as import licensing may act in a manner which convert tradeable to essentially non-tradeable commodities by excluding all or large parts of potential import competition.

[2] This view was expressed succinctly last year by the Australian Foreign Minister, Mr Hayden, in his comments about "embalming geriatric industries in the formaldehyde of protection".

APPENDIX

PRIORITIES FOR REFORM : EXTRACT FROM SYNTEC STUDY

Consistent with the aims of achieving substantial benefits sooner rather than later and minimising avoidable adjustment costs, it is possible to identify several priorities for assistance reform:

- reducing high assistance-there is no reason to repeat here why this is of the highest priority;
- reducing the scope for substantial increases in assistance to occur in response to the changing needs of industry. Provision of assistance on the basis of an industry's needs can reduce the incentive of firms to improve productive efficiency. Moreover, under a needs-based system, where particular activities are becoming progressively less competitive because of changes in the world or domestic trading environment, their assistance levels are raised accordingly, thus impeding adjustment of resource use to changing economic circumstances;
- modifying, removing or replacing interventions which provide highly uneven assistance for closely related groups of products or which significantly distort input use. Several forms of assistance introduce substantial distortions in resource use within industries. It would be desirable to correct these, irrespective of what happens to inter-industry assistance disparities;
- eliminating interventions which involve substantial administrative or Ministerial discretion, complex administrative procedures or high administration and compliance costs relative to the assistance provided;
- increasing the transparency of the assistance structure.

Source: Syntec Economic Services: *The Structure of Industry Assistance in New Zealand: An Exploratory Analysis,* (February 1984), page 43.

Chapter Fifteen

Limitation of Competition Among Exporters of Primary Products

Introduction

A very significant intervention by the Government into agriculture and horticulture is the granting, by legislation, to producer boards and authorities the power to limit competition in the export of the products for which they are responsible. This limitation can be effected by product acquisition (i.e. the board or authority as single seller), by restricting the number of exporters (i.e. by making exporters subject to licence), by compulsory levies (e.g. for research, administration, promotion etc.), or by imposing various restrictions on exports (e.g. as to price and quality).

Given the importance of primary exports to the **New Zealand economy,** this form of government intervention needs particularly careful scrutiny. As noted below, the great majority of New Zealand's primary products are subject to some form of control which removes or limits competition among exporters.

Historical Evolution

Generally, in its early stages, each industry consisted of a large number of independent producers dealing with a much smaller number of exporters who were perceived by producers as not obtaining the maximum return for their product. Producers attributed this to incorrect marketing strategies. They responded by forming voluntary organisations such as co-operatives so as to integrate their activities and strengthen their market power base. Often these associations were not able to improve returns to producers and their performance too fell below producer expectations. The third phase, then, has been for producer groups to lobby for statutory control of marketing organisations and marketing services. Typically, the result has been legislation creating a producer-dominated marketing authority with extensive powers to regulate the export of product through either licensing or compulsory acquisition.

Historically, the control of export marketing through producer boards has been associated with compulsory stabilisation schemes which have attempted to even producer incomes between seasons with high and low returns. The objective of these schemes, as they are now operated, is primarily to reduce the private risk to producers. This objective should be separated from the objectives of limiting competition amongst exporters. Consequently, the control of stabilisation schemes by the authority that also controls exports is, more than anything else, a matter of administrative convenience.

The granting of controls over exports to producer boards has at times been justified in the interests of producer control. Whether producer control *per se* (as opposed to the economic consequences of producer control) is desirable is a matter on which economics is necessarily silent. However, it should be noted that in practice producer control means control by some producers over all producers and by some present producers over potential new producers as well as existing producers. Insofar as there are links between export and domestic prices, producer control has implications for domestic consumers as well as for producers. Also, if the effects of producer controls are to distort resource allocations, the cost will be borne by the nation and not just by the producers. For these reasons 'producer control' involving compulsory powers provided by statute has implications for the nation and not just for the industry.

Current Situation

Virtually all significant primary product exports are now actually or potentially subject to producer board control. A major exception is wool most of which is sold by auction. The Dairy Board has long been the sole exporter of dairy produce. The Apple and Pear Board is the sole exporter of apples and pears. Since 1982 the Meat Producers Board has compulsorily acquired all export sheepmeat. The Fishing Industry Board is empowered to control fish exports. Producer board control is also being extended into newer forms of primary produce. The exports of kiwifruit, raspberries, boysenberries and blackcurrents are subject to controls. In addition, the Horticulture Export Authority Bill, which was recently introduced into Parliament, will, if it becomes law, make it easier for horticultural producer groups to acquire the ability to control exports. Regulations to establish a goat fibre authority are under consideration: as presently envisaged, these would provide for the establishment of an authority with power to license exporters and exact levies.

Implications for Resource Mobility

The national benefit requires that resources flow as freely as possible among different activities according to their relative profitability at any particular time. Impediments to such mobility of course exist but in the national interest these should be reduced, and eliminated where possible, rather than increased. One such impediment can be called "policy uncertainty" -that is, the costs and risks associated with exposure to licensing procedures and powers of compulsion. These are disincentives to investment by new entrants because they add, to the ordinary costs and risks of exporting, the costs associated with getting licences and observing their conditions and the risk that the rules may change.

Conditions Justifying Controls

a "Voluntary" Restraints on Imports

There are circumstances which justify export controls. These arise from the characteristics of markets, not of products as such. For example, New Zealand's lamb exports to the EEC are limited to 245,000 tonnes a year (at present) under a "voluntary restraint" arrangement but sales in that market fetch a better price than other markets offer. Someone has to ensure that this quota is filled but not exceeded, and collect the extra profit-the "rent" from that market. There are parallels in the dairy trade and in the markets for apples. The particular mechanisms adopted, which are operated by the producer boards, cause problems of their own; for example, the averaging of prices paid to producers calls forth production which costs more to achieve than it earns in the lowest-paying, "residual" markets. Where domestic prices move in line with export prices the effect of spreading rents from quota markets across all product will be a level of domestic prices higher than what would be the outcome if no averaging took place. However, there would also be problems if no mechanisms existed. In the cases of meat and dairy exports, Board control can be regarded as a necessary response to the protectionist policies of the EEC and some other countries-policies which coerce New Zealand to assist in their implementation. The problems caused by averaging of prices could be avoided by auctioning export entitlements equal in aggregate to the "voluntary" restraint limit. This would result in quota rents being paid into the consolidated account and would avoid the distortionary effects of price averaging. This would also of course deny domestic producers the quota rents and any transfer from domestic consumers.

b Ability to Influence Export Prices

There can be another market characteristic justifying industry control— limited or no competition so that New Zealand can influence prices so as to maximise total profit. World dairy trade occurs in such a market because New Zealand accounts for a large share of that trade and co-operates with other major exporters. (Between them New Zealand and the EEC account for over 70 percent of that trade.) However, New Zealand's dairy exports are only a small proportion of world production and this consideration, together with the current surplus situation, limits

New Zealand's ability to influence prices. The kiwifruit market is another, at present, because New Zealand is the principal producer. However, the prices achieved for these products are limited by "substitutability''-the readiness of consumers to use substitute primary products (e.g. white meat for red meat) or to spend their money on other things. Moreover, given their predominantly producer orientation it is highly questionable whether producer boards could in practice effect the reductions in export quantities that would be necessary to raise export prices significantly.

Regulation of the Market-Licensing

The major regulatory function possessed by a number of boards is the power to licence exporters. This power enables the relevant producer group to exercise control not only over who can export the product but also over the quality and quantity that may be exported to a particular market and the price at which it may be sold. The producers' objective in seeking this power is to maximise returns to themselves by limiting the independence of exporters. Proponents of licensing have suggested that the total net returns to New Zealand from a market (e.g. the United States blueberry market) can be increased by:

a eliminating the phenomenon known as "weak selling";

b influencing market prices;

c ensuring an exporter undertakes adequate promotion;

d maintaining quality standards; and

e guaranteeing effective and efficient distribution.

a **Weak** *selling*

"Weak selling" describes a situation where New Zealand sellers undercut each other in order to make a sale. Weak selling, it is argued, occurs when there are no restrictions on the number of New Zealand exporters allowed into a market and as a consequence "too many New Zealand sellers chase too few buyers". Implicitly, supporters of this view would contend that there is an optimum number of New Zealand sellers for any market and that this number can be determined by an Export Authority.

By implication, those making the claim of weak selling have a different view of the future market than does the seller (i.e. they think a higher price can be sustained than is expected by the seller). It is conceivable that the so-called weak seller may have mistaken the market and missed the opportunity for a higher return : however, in a competitive market environment any firm which consistently mis-judged market conditions would be unable to compete against those having better judgments and would soon be out of business.

For products for which the demand increases as the price falls an efficient seller, through offering lower prices, may be able to increase its share and possibly the nation's share of the market. This in fact is a widespread phenomenon as products become better known and producers sell more products at a lower price and a higher total profit. For instance, the world price of avocados has fallen and is expected to fall further for these reasons, as has the price of electronic products for the last couple of decades. Therefore price cutting, even as a widespread trend, can be desirable because it is total profit, not just profit per unit, which matters to the nation.

Markets for most primary products are complex. As with other goods prices vary considerably amongst sellers because each seller is offering a different package of goods and services (reliability, payment period, packaging, quality, delivery etc.) tailored to their particular view of where the most profitable opportunities lie. The lower prices offered by some firms may reflect, therefore, the more limited services they are offering. This is not necessarily evidence of weak selling. Nor does New Zealand's comparative advantage necessarily lie in the growing of high quality produce directed towards the upper end of the market. There may be greater advantage in selling a less costly combination of product and associated services to a lower price market segment. There is no *a priori* correct strategy. The most profitable strategy may vary from market to market and from year to year or even month to month; the best strategy for any particular time and place is a purely empirical question.

In summary, Treasury does not see that exporters of most primary products face greater incentives for weak selling than, say, exporters of manufactured products. We acknowledge, of course, that being seasonal products the prices of primary products can vary considerably. However, we contend that downward trends in prices do not necessarily result from weak selling but arise as a consequence of the difference in profitability of alternative marketing strategies. We are, therefore, firmly of the opinion that so-called "weak selling" is not in most cases a valid reason for licensing exporters.

b *Influencing Market Prices*

New Zealand's ability to influence prices on the world market and in individual markets rests on its share of the market and the availability of substitute products. New Zealand has a sizeable market share in only a few of its primary products. If, as is the case for most horticultural products, New Zealand's market share is relatively small then limiting sales in order to raise prices and revenue would not increase the return to the nation. Rather it would simply transfer New Zealand's sales to producers in other countries. The goat fibre industry in New Zealand is another good example : its present annual output is about 30 tonnes whereas world output is about 20,000 tonnes.

It seems clear that New Zealand producers will always be price takers rather than price setters and that limiting our exports would have minimal effect on world prices. Also, most products have close substitutes from which consumers choose as prices change. Orange roughy, for instance, is a premium white fish found only in New Zealand waters but, on the United States market, it competes not only with other fish products but also with red and white meats. This further constrains New Zealand's ability to influence export market prices. Even in the instances where New Zealand can exert some influence on the world market price or the prices on specific markets it is questionable whether it is in the nation's long-term interest to do so. Setting prices above true market levels may restrict the size of a market by influencing consumers to divert their expenditures to other areas and, as well, attract new entrants into production in other countries, if not in New Zealand. The end result, in subsequent seasons, may be an increase in supply coinciding with stagnant demand leading to downward pressure on prices or to product remaining unsold, or both.

c Promotional Requirements

One reason advanced in support of the need to license entry into export markets is that without some form of regulation, total investment by New Zealand firms in promotional activity will be inadequate because some of the benefits from a firm's investment in promotion spill over to other firms. A firm's ability to retain the benefits of its investment in promotion, however, depends on the product type and the nature of the promotional activity. Generally, the newer the product is to the market and the less it can be differentiated from its competitors product, the more difficult it will be for a firm to retain the benefits of its promotion. Promotional activity can generally be divided into two types. Promotion which is directed towards differentiating between a company's product and those of its competitors (e.g. Sunkist oranges) benefits only the investing company and is unlikely to contribute to sales of other companies. On the other hand, export promotion aimed at increasing demand for a generic product (e.g. peaches) may, to some degree, spill over to all the firms selling that product including firms selling produce that does not originate in New Zealand.

Exporters normally use generic promotion for products which are new to a market and for which there is only limited competition from other countries (e.g. kiwifruit to Germany or orange roughy to the United

States). For markets of this type there may be a case for restricting the number of sellers in a particular market when an exporter cannot otherwise recoup his investment in market development. However, the same objective might be better obtained through other means. To retain the benefits from promotional activity exporters have a strong incentive to differentiate their products according to the entire bundle of services provided including quality, delivery, reliability, guarantees, packaging, processing and so forth. Alternatively, firms may find it to their advantage to co-operate voluntarily to fund promotion, or funding of common promotion may be organised through producers' groups by way of voluntary (or compulsory) levies. In the case of horticultural products it should be noted that very few of the products that may come under the proposed Authority's umbrella are new to a market or have only limited competition from other countries.

Hence, even for products which are not readily differentiated according to character (e.g. peaches), the costs and benefits for an individual firm from undertaking promotional activity are usually similar to the national costs and benefits of such activity. Where this is not the case, remedial regulations should be designed to minimise the serious effects of licensing on competition. One way is to require firms to bid for market rights (i.e. tender for licences). Of course, new products do not stay new and competition from other countries always arises. Consequently any licences issued to stimulate promotion should contain a sunset clause. An alternative solution in this limited case might be a levy on exporters to fund joint promotional activity (this is discussed in more detail below). Overall, however, we consider that the incentive of profit to individual exporters is a much more appropriate way to generate an adequate level of promotion than to collect the views of producers and express them through a producer board.

d *Quality Standards*

The maintenance of high and consistent quality standards (of appearance, hygiene, etc.) due to the export licence conditions set by the Kiwifruit Authority is frequently cited as one of the major reasons for the success of the kiwifruit industry. Such standards, it is argued, give buyers confidence in the product and help to sustain high prices. Supporters of this view consider that it is in New Zealand's interest to adopt a similar approach for other primary products. This type of approach, however, ignores the fact that markets consist of a variety of buyers with differing preferences as among price, quality and reliability of product. Consequently, by instituting regulations which insist on the export of only high quality produce, New Zealand may be denying producers access to other potentially profitable markets or market segments where a lower standard and price are demanded. Further, mandating costly high quality standards will reduce returns to growers and to the nation from markets which do not carry an adequate premium for quality.

The communication of product quality does not require an authority to set minimum export standards, but rather requires the establishment of a range of product descriptions, readily understood overseas, which guarantee that each buyer receives for his money the type of product he requires. If individual exporters have difficulties obtaining recognition for their own quality standards then there may be a case for a centrally-based and internationally recognised grading system which exporters would pay for should they see benefit in belonging. There is, however, in our view no case for the enforcement of quality standards by export licensing.

e Efficient Distribution

Effective and efficient distribution arrangements are essential to the successful export of primary products, and can require investment in storage, here and overseas, as well as good Organisation. Obviously there can also be economies of scale. These considerations have led some to argue that powers of compulsion, through licensing, are required in order to ensure effective and efficient distribution.

On analysis this argument is not convincing. At the local level producers do co-operate and will continue to co-operate in the provision of storage and transport. New Zealand is generally exporting in the Northern Hemisphere's off-season and the availability of offshore storage and specialised transport is not usually a problem. However, even if it were, economies of scale can be realised equally by individual firms of sufficient size, by voluntary groupings of smaller firms, and as is most common, by contractual arrangements between individual New Zealand firms and overseas partners or agents. The diversity of products and markets suggests that there is no one best way to distribute all products. Rather, the variety of their characteristics and the constant changes in costs, prices and destinations point to the need for an equal variety of distribution arrangements and the desirability of flexibility and adaptability. These latter tend to accompany freedom of contract, not licensing and compulsion.

Regulation of the Market-Compulsory Levies (Export Taxes)

Compulsory levies on export products are commonly justified on two grounds. The first is the need for market services where individual firms are unable to prevent some of the benefits from their investments (in generic promotion, for example) from flowing to competing firms. They are correspondingly reluctant to make the investment. This may lead, in some cases, to an under-supply of a particular market service or, in the extreme case, to no provision at all. The second justification advanced is that services such as market intelligence, product research etc. have elements of “common good”, whereby consumption by one firm does not significantly reduce the amount available to other firms, and common sources may be more economic than individual efforts.

That market failures of these kinds do exist, from time to time, is not at issue. Some market services do have “common good” characteristics. The questions that must be addressed, however, are whether the institution of compulsory levies would necessarily improve matters and whether it is the most efficient method of dealing with the two types of market failure outlined above.

Firms are primarily motivated by a profit incentive and act accordingly. Thus in the instances when it is in their interest to co-operate voluntarily with other firms (e.g. in the provision of some types of market intelligence) they will do so, and within an environment that is conducive to the efficient provision of such a service. Similarly, when “spillover” of market services is likely to occur, firms will differentiate their product and services so as to minimise any benefits from their investment going to competitors.

Likewise the same behaviour can be ascribed to individual producers. As has been observed in the horticultural industry so far (e.g. the New Zealand Nurserymen’s Association etc.) producers will organise in voluntary groups and contribute to the provision of market services when, and only when, it is in their interest to do so (e.g. the stonefruit export levy). The voluntary nature of these groups ensures that they perform in the interests of their members.

In contrast, the same cannot be said for product groups or an export authority funded by a compulsory levy. The fact that membership, through the payment of a levy, is compulsory reduces the incentive for the product group or authority to perform. Furthermore, it is extremely difficult for a marketing authority to determine the optimum amount that should. be levied and, if it is not directly involved in trading, exactly where it should be spent to best advantage. In addition, as it is common to subsidise services or provide them free to those who are levied, contributors have little or no incentive to curb their demand for these services. Together, all these factors lead to the conclusion that the use of compulsory levies is likely to be an inefficient method of providing market services.

Treasury is of the view that in most cases voluntary market groupings funded by voluntary contributions provide an environment in which the appropriate incentives exist for the efficient provision of market services.

Compulsory levies, in comparison, do not provide adequate incentives for the efficient provision of market services and thus cannot be considered superior in rectifying the two general market imperfections that are used to justify them.

Conclusion

In Treasury's view market competition between exporters or their agents should not be seen as a destructive process, but as a positive process whereby firms are able to identify market opportunities for a range of goods and services, and to test them against alternatives with regard to the incentive of profitability. A major drawback to the institution of export market controls, whether they be through acquisition, export market licensing or export levies, is that because they restrict competition it is virtually impossible to monitor their effectiveness. In comparison, the fact that in the unrestricted situation firms will try different marketing approaches, adopt different pricing policies and offer different ranges of services is of benefit, and not detrimental, to our ability to compete on international markets in the future. Furthermore, the belief that there is a very restricted number of correct approaches to marketing is, as we are constantly reminded in our own changing consumption habits, not true, and if adopted could undermine New Zealand's export competitiveness.

A danger of export licensing is that, by setting conditions that reduce competition between existing exporters, incentives are reduced for exporters to innovate, to experiment and to seek cost efficiencies in their operations. In effect such licensing acts to legitimise the activities of the established producers/exporters-some of whom are supposedly now performing less than adequately. At the same time it restricts the entry of new exporters to the market despite the fact that innovation and growth have historically depended very heavily on new firms. Moreover, by reducing the incentives for exporters to use resources efficiently, licensing carries a cost for society as a whole. While it may well be to the benefit of established producers Treasury has, as yet, not seen any detailed analysis of the national benefits expected from the regulation of competition amongst exporters. In general, we think it unlikely that any benefits from licensing would outweigh the future costs to the nation that would follow from a weakening in the incentive for good export performance.

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